MAKING SAUSAGE NO ONE WANTS TO EAT: OPTIONS FOR RESTRUCTURING ILLINOIS'S PENSION DEBT

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The State of Illinois currently owes nearly $100 billion in unfunded public pension liabilities, and it is projected that nearly twenty percent of the State's spending in the current fiscal year will go to pension obligations. While the funding shortfalls are primarily attributable to decades of the General Assembly's irresponsibility, the cause of the problem is secondary. Illinois's public pension systems as currently structured are unsustainable.

This Note analyzes three proposals for restructuring Illinois's pension debt and offers a recommendation for the best method of approaching the problem. First, the Note examines proposals to amend the federal bankruptcy code to allow states to file bankruptcy and concludes that the costs of state bankruptcy outweigh the benefits. Second, it analyzes the political solutions available under current Illinois law and explains the potential constitutional barriers to reform. Third, it presents a novel approach that involves establishing a State Public Pension Funding Commission to work out state pension debts. The Commission, created at the federal level, would be able to navigate state and federal constitutional difficulties while preventing the State's default or a federal bailout. Ultimately, this Note recommends a combination of state legislative reform—including increasing the retirement age and decreasing cost-of-living adjustments—and implementation of a federal public pension funding commission to take over if state reforms are not enacted or are unsuccessful.

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I. INTRODUCTION

The State of Illinois has many creditors.[1] It has tens of thousands of employees,[2] pays millions every year servicing its debt,[3] owes billions of dollars in payments to state contractors,[4] and maintains retirement and health insurance systems for its employees.[5] Through decades of mismanagement, Illinois's five state-run pension systems are now underfunded by billions of dollars.[6] In fact, Illinois has the worst-funded pension system in the country.[7] It is undeniable that to meet its obligations under current law, Illinois will have to spend more.

Yet Illinois already commits over seventeen percent of its general operating budget to pension payments.[8] Given the future liabilities that will inevitably come due, this is a comparable expense to health-care spending in the federal budget.[9] An analysis of the Illinois state budget projects that yearly pension costs will rise from $5.7 billion in fiscal year (FY) 2012 to $7.8 billion by FY2017.[10] Between unfunded pension liabilities and rising Medicaid costs, the State will have an estimated $34.8 billion in total unpaid bills by FY2017.[11] While Medicaid obligations and rising health-care costs are serious problems that must be part of any solution to the State's fiscal problems,[12] they are outside the scope of this Note. The State must take many steps to pull back from the brink of fiscal disaster, but any solution will have to deal with the mounting pension problem.

1. *See* Tim Jones & Melissa Silverberg, *Indebted Illinois Stiffs Creditors From Funeral Homes to Xerox*, BLOOMBERG (June 23, 2011, 11:01PM), http://www.bloomberg.com/news/2011-06-24/illinois-stiffs-vendors-from-mortuary-to-ibm-as-4-billion-debt-piles-up.html.

2. Andrew Thomason, *Fewer State Employees, but Higher Paychecks*, ILLINOISWATCHDOG.ORG (Sep. 2, 2011), http://watchdog.org/39973/ilsh-fewer-state-employees-but-higher-paychecks/.

3. INST. FOR ILL. FISCAL SUSTAINABILITY, CIVIC FED'N, STATE OF ILLINOIS FY2013 BUDGET ROADMAP 6 (2012) [hereinafter FY2013 BUDGET ROADMAP], *available at* http://www.civicfed.org/sites/default/files/FY2013%20Illinois%20State%20Budget%20Roadmap.pdf.

4. Jones & Silverberg, *supra* note 1.

5. *See, e.g.*, STATE EMPS.' RETIREMENT SYS. ILL., http://www.state.il.us/srs/sers/home_sers.htm (last visited Mar. 10, 2013); STATE U. RETIREMENT SYS. ILL., http://www.surs.com/homepage.surs (last visited Mar. 10, 2013); TEACHERS' RETIREMENT SYS. ILL., http://trs.illinois.gov/ (last visited Mar. 10, 2013).

6. ILL. RETIREMENT SEC. INITIATIVE, CTR. FOR TAX & BUDGET ACCOUNTABILITY 2 (Aug. 2011), *available at* http://www.ilretirementsecurity.org/admin/reports/files/UPDATED-8.11.11-Illinois-State-Employee-Retirement-Benefits-Chart.pdf.

7. *See* PEW CTR. ON THE STATES, THE WIDENING GAP: THE GREAT RECESSION'S IMPACT ON STATE PENSION AND RETIREE HEALTH CARE COSTS 3 (2011) [hereinafter THE WIDENING GAP], *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2011/Pew_pensions_retiree_benefits.pdf.

8. *See* INST. FOR ILL. FISCAL SUSTAINABILITY, CIVIC FED'N, STATE OF ILLINOIS ENACTED BUDGET FY2012 3 (2011) [hereinafter FY2012 BUDGET REPORT], *available at* www.civicfed.org/sites/default/files/state%20of%20Illinois%20Enacted%20Budget%20FY2012.pdf.

9. *See Policy Basics: Where Do Our Federal Tax Dollars Go?*, CTR. ON BUDGET & POL'Y PRIORITIES (Aug. 13, 2012), http://www.cbpp.org/cms/index.cfm?fa=view&id=1258.

10. FY2013 BUDGET ROADMAP, *supra* note 3, at 2.

11. *Id*.

12. *Id*.

This Note looks at the options available to Illinois to restructure its pension obligations. Part II provides background information on Illinois's pension systems, the scope of its debt problems, and the legal and political context for restructuring that debt. Part III analyzes three possible approaches: a state bankruptcy proposal modeled on chapter 9 of the United States Bankruptcy Code, a political approach under current Illinois law, and a novel, but inchoate, proposal for a State Public Pension Funding Commission that would be more legally powerful than a political approach but more narrowly tailored to the task of pension reform than a bankruptcy provision. Part IV recommends employing a political approach and offers a list of specific actions that the Illinois General Assembly ought to take, while leaving open the possibility of a State Public Pension Funding Commission as a last resort. Finally, Part V concludes.

II. BACKGROUND

To arrive at an effective resolution, some background on the source of Illinois's pension problems and the options available for addressing these problems is necessary. This Part focuses on what the State's pension obligations are, the legal structure of those obligations, and the available options for restructuring them.

A. Illinois's Pension Obligations

Generally, pension systems are structured as either "defined-benefit" plans or "defined-contribution" plans.[13] In a defined-benefit plan, the retired employee draws a fixed periodic payment from a general pool of assets instead of an individual account.[14] Though contributions come from either the employer or the employee, the employer bears the investment risk and must cover any funding shortage.[15] Defined-contribution plans, on the other hand, consist of an individual account associated with each participant.[16] Again, both the employee and employer may contribute, but the employer's contribution is fixed, and the employee's benefits upon retirement correspond to the amount contributed, factoring in any investment gains or losses.[17]

Currently, the pension systems for which the State is primarily responsible for funding are defined-benefit plans.[18] The Illinois Pension

13. 60A AM. JUR. 2D *Pensions* § 15 (2003).
14. *Id.*
15. *Id*.
16. *Id*. § 16.
17. *Id*.
18. *See* JOURLANDE GABRIEL & CHRISSY A. MANCINI, CTR. FOR TAX & BUDGET ACCOUNTABILITY, ILL. RET. SEC. INITIATIVE, THE ILLINOIS PUBLIC PENSION FUNDING CRISIS: IS MOVING FROM THE CURRENT DEFINED BENEFIT SYSTEM TO A DEFINED CONTRIBUTION SYSTEM AN OPTION THAT MAKES SENSE? 2 (2007).

Code contains provisions for the governance of many different pension funds.[19] But the State is only directly obligated to fund five of these: the General Assembly Retirement System (GARS),[20] the State Employees' Retirement System of Illinois (SERS),[21] the State Universities Retirement System (SURS),[22] the Teachers' Retirement System of the State of Illinois (TRS),[23] and the Judges Retirement System of Illinois (JRS).[24] The State is required to "meet the costs of maintaining and administering" these five systems "on a 90% funded basis in accordance with actuarial recommendations."[25] The State is not the sole entity responsible for funding the system; employee and employer funds must contribute as well.[26] The terms of the Pension Code and the Board created by statute

19. *See* 40 ILL. COMP. STAT. 5/2-101 (2010) (General Assembly Retirement System); *id.* § 5/3-101 (Police Pension Fund–Municipalities 500,000 and Under); *id.* § 5/4-101 (Firefighters' Pension Fund–Municipalities 500,000 and Under); *id.* § 5/5-101 (Policemen's Annuity and Benefit Fund–Cities Over 500,000); *id.* § 5/6-101 (Firemen's Annuity and Benefit Fund–Cities Over 500,000); *id.* § 5/7-101 (Illinois Municipal Retirement Fund); *id.* § 5/8-101 (Municipal Employees', Officers', and Officials' Annuity and Benefit Fund–Cities Over 500,000 Inhabitants); *id.* § 5/9-101 (County Employees' and Officers' Annuity and Benefit Fund–Counties Over 3,000,000 Inhabitants); *id.* § 5/10-101 (Forest Preserve District Employees' Annuity and Benefit Fund); *id.* § 5/11-101 (Laborers' and Retirement Board Employees' Annuity and Benefit Fund–Cities Over 500,000 Inhabitants); *id.* § 5/12-101 (Park Employees' and Retirement Board Employees' Annuity and Benefit Fund–Cities Over 500,000); *id.* § 5/13-101 (Metropolitan Water Reclamation District Retirement Fund); *id.* § 5/14-101 (State Employees' Retirement System of Illinois); *id.* § 5/15-101 (State Universities Retirement System); *id.* § 5/16-101 (Teachers' Retirement System of the State of Illinois); *id.* § 5/17-101 (Public School Teachers' Pension and Retirement Fund–Cities of Over 500,000 Inhabitants); *id.* § 5/18-101 (Judges Retirement System of Illinois).

20. *Id.* §§ 5/2-124, 125 (mandating that the State make contributions to GARS necessary to maintain ninety percent funding).

21. *Id.* §§ 5/14-131, 132 (mandating that the State make contributions necessary to maintain ninety percent funding).

22. *Id.* §§ 5/15-155, 156 (mandating that State make the required contributions, disburse all benefits granted under this provision, and pay all expenses of operation and administration).

23. *Id.* § 5/16-158 ("The State shall make contributions to the System by means of appropriations . . . which, together with other employer contributions, employee contributions, investment income, and other income, will be sufficient to meet the cost of maintaining and administering the System on a 90% funded basis . . . .").

24. *Id.* §§ 5/18-131, 132.

25. *See supra* notes 20–24.

26. *See, e.g.*, 40 ILL. COMP. STAT. 5/14-131 (providing for State contributions to SERS "together with other employer contributions from trust, federal, and other funds, employee contributions, investment income, and other income"); *id.* § 5/16-158 (providing for State contributions to TRS "together with other employer contributions, employee contributions, investment income, and other income"). "Employer" in this context typically refers to the department, college or university, or local school district in which the employee works. *See id.* §§ 5/14-103.04, 133.1; *id.* § 5/15-106. While the section of the Pension Code governing TRS does not explicitly define "employer," it implicitly defines an "employer" as an entity employing a "teacher." *Id.* Notably, employer contributions under TRS are relatively small at just 0.58% of salary. *Id.* § 5/16-158(e). A proposal to shift more of the cost to local school districts—i.e., "employers"—is a central issue in current pension reform discussions. *See* ILL. RETIREMENT SEC. INITIATIVE, ISSUE BRIEF: SHIFTING THE NORMAL COST & EMPLOYER "PICK-UPS" FOR TEACHERS 1 (Mar. 2012), *available at* http://www.ctbaonline.org/New_Folder/Pension/issue%20brief%20SHIFTING%20THE%20NORMAL%20COST%20%20EMPLOYER%20PICK-UPS%20FOR%20TEACHERS.pdf.

define the levels of contributions by each obligor for these systems, but the State bears the bulk of the funding burden.[27]

Regardless of the system's structure, members of Illinois state retirement and pension systems have a right under the Illinois Constitution to receive their benefits.[28] Article XIII, section 5 of the Illinois Constitution provides the following: "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."[29] The purpose of this provision was to "eliminate the uncertainty that surrounded public pension benefits."[30] The problem, however, is that the State has not met its funding obligations, making compliance with article XIII, section 5 difficult.

B. Funding Problems

Added together, the five State-funded pension systems have roughly $96.8 billion in unfunded liabilities.[31] As of June 30, 2012, TRS was 40.6% funded with an unfunded liability of $53.5 billion.[32] Likewise, SERS was 33.1% funded as of June 30, 2012.[33] SERS had total unfunded liabilities of $22.1 billion.[34] In addition, SURS was at a 41.3% funded level, with almost $19.5 billion in unfunded liabilities.[35] While smaller, GARS and JRS are also severely underfunded. As of June 30, 2012, GARS was only 17.4% funded, and its unfunded liability was nearly $258 million.[36] JRS was 28.6% funded with unfunded liabilities of approximately $1.4 billion.[37] The numbers are bad, but they could get worse.

The State's ability to make the required contributions and reach the ninety percent funding level is far from certain. Commentators have questioned the assumed rates of return.[38] TRS based its numbers on an actuarial assumption of an 8.0% annual return on investment.[39] As of

27. *See, e.g.*, Master Agreement between Dep't of Cent. Mgmt. Servs. and Am. Fed. of State, Cnty. and Mun. Emps. Council 31, AFL-CIO 65–67 (2008–2012), *available at* http://www2.illinois.gov/cms/Employees/Personnel/Documents/emp_afscme1.pdf.

28. *See* ILL. CONST. art. XIII, § 5.

29. *Id*.

30. People *ex rel.* Sklodowski v. State, 695 N.E.2d 374, 377 (Ill. 1998).

31. DAN HANKIEWICZ, COMM'N ON GOV'T FORECASTING & ACCOUNTABILITY, SPECIAL PENSION BRIEFING 3 (2012), *available at* http://www.ilga.gov/commission/cgfa2006/Upload/1112SpecialPensionBriefing.pdf.

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. THE WIDENING GAP, *supra* note 7, at 8.

39. TEACHERS' RET. SYS. OF THE STATE OF ILL., COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2012, at 93 (2012), *available at* http://trs.illinois.gov/subsections/pubs/cafr/fy12/fy12.pdf. TRS reduced its assumed rate of return on invest-

September 30, 2012, TRS's ten-year return on its investments was 8.2%.[40] SERS's liabilities are based on an actuarial assumption of a 7.75% rate of return,[41] yet it has received an actual return of 3.1% over the past five years.[42] Even based on this estimate, the most recent SERS financial report explains that the State would need to make the same level of contributions as a percentage of payroll for the next thirty-five years to reach the statutorily mandated 90% funding level.[43]

But prolonged economic doldrums make 8% returns unlikely.[44] Accordingly, scholars have called for basing return estimates on a risk-free rate such as the yield on United States Treasury securities.[45] The rationale is that under current law the State is required to make pension payments regardless of its investment returns, so it should base its funding on the rate that will allow it to meet its obligations in any scenario.[46] Government officials are hesitant to move too far in this direction, however, because a decrease in the assumed rate of return would increase the State's required contribution levels significantly.[47]

Adding to the uncertainty over its future ability to meet its obligations, the State's pension contributions in recent years have come from the proceeds of pension obligation bonds.[48] The State borrowed $10 billion in 2003, $3.5 billion in 2010, and $3.7 billion in 2011 to meet its pension obligations.[49] One commentator has estimated that the present value of the pension obligation bond debt added to the official unfunded liability puts the "total pension burden" at $102.8 billion.[50] This has already added to the State's long-term burden; the enacted FY2012 budget contains appropriations for debt service in the amount of $1.6 billion for these bonds.[51] Total pension-related appropriations (contributions plus debt service) in the FY2012 budget will be $5.8 billion.[52] This accounts

ments from 8.5% to 8.0% in FY2012, which contributed, in part, to the increase in its unfunded liability. *Id.* at 28, 93.

40. *Investments*, TEACHERS' RETIREMENT SYS. STATE ILL., http://trs.illinois.gov/subsections/investments/investments.htm (last visited Mar. 10, 2013).

41. STATE EMPS.' RET. SYS. OF THE STATE OF ILL., COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2011, at 27 (2012), *available at* http://trs.illinois.gov/subsections/pubs/cafr/fy11/fy11cafr.pdf.

42. *Id*. at 39.

43. *See id*. at 27.

44. *See* THE WIDENING GAP, *supra* note 7, at 8.

45. *See, e.g.*, Andrew G. Biggs, *Proposed GASB Rules Show Why Only Market Valuation Fully Captures Public Pension Liabilities*, FIN. ANALYSTS J., Mar.–Apr. 2011, at 18, 18.

46. THE WIDENING GAP, *supra* note 7, at 8.

47. *Id*.

48. *See* FY2012 BUDGET ROADMAP, *supra* note 3, at 23.

49. AMANDA GRIFFIN-JOHNSON, ILL. POLICY TRUST., ILLINOIS' PENSION BONDS 1 (2011), *available at* http://illinoispolicy.org/uploads/files/pensionbonds10-20.pdf.

50. *Id*.

51. FY2012 BUDGET REPORT, *supra* note 8, at 33.

52. *Id*.

for 17.4% of total general funds expenditures, placing pensions among the State's largest expenses.[53]

Obstacles to the State meeting its pension funding obligations include rising costs elsewhere in the budget. In particular, the costs of Medicaid will continue to grow,[54] and the State must continue to service its debt.[55] Medicaid payments will account for $13.9 billion in FY2012, and the federal government only reimburses the State for roughly half of those costs.[56] But the State's share of Medicaid payments to health-care providers is mandated by federal law.[57] In attempts to balance the budget, the General Assembly has cut Medicaid appropriations, but this does not curtail the actual costs.[58] Normally, the State must pay its bills from appropriations of the fiscal year in which they come due.[59] But the State has been using a loophole in the State Finance Act to use appropriations from the following year to make Medicaid payments.[60] This has led to a $2.7 billion structural deficit in the Medicaid program.[61]

Debt service is also straining the State's finances. The State's total debt payments from the general funds for the FY2012 will be $2.8 billion.[62] This excludes special revenue bonds, which are secured by income from particular revenue sources.[63] While debt service is a burden, the costs of defaulting on bond obligations are simply too great.[64] Default would have an adverse effect on the state's credit rating and raise future borrowing costs, and it would likely unsettle municipal bond markets across the United States.[65]

As a result, two of the State's primary liabilities, Medicaid payments and debt service, will be difficult to restructure. As this has been true for quite some time, the State has fallen behind on other payments where it

53. *See id*.

54. *See* JONATHAN INGRAM, ILL. POLICY INST., MEDICAID FAIL: WHY CUTTING APPROPRIATIONS DOESN'T CONTROL COSTS, ILL. 1 (2011), *available at* http://illinoispolicy.org/uploads/files/medicaidfailPP11-8_1.pdf.

55. *See* FY2012 BUDGET REPORT, *supra* note 8, at 33.

56. *Id*. at 27.

57. *See* INGRAM, *supra* note 54, at 1 ("When a doctor sees a Medicaid patient, he bills the state for services provided under these guidelines. [State and federal law requires that] [t]hose bills must be paid.").

58. *Id*.

59. 30 ILL. COMP. STAT. 105/25(a) (2010).

60. INGRAM, *supra* note 54, at 1.

61. ILL. DEP'T OF HEALTHCARE & FAMILY SERVS., MENU OF POSSIBLE OPTIONS FOR MEDICAID LIABILITY AND SPENDING REDUCTIONS 3 (Feb. 2012), *available at* http://www2.illinois.gov/hfs/agency/Documents/022212_presentation.pdf.

62. FY2012 BUDGET REPORT, *supra* note 8, at 33.

63. *See id*. at 2 n.1.

64. *See* Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy*," 59 UCLA L. REV. 322, 324–25 (2011).

65. *Id*.

had some room to maneuver, namely payments to vendors and pension obligations.[66]

Some pension fund beneficiaries have sought to enforce the State's funding obligations in court.[67] In *People ex rel. Sklodowski v. State*, members of various state retirement systems—including TRS, SERS, and SURS—sought mandamus, declaratory relief, and injunctive relief to force the State to meet its funding obligations under the Pension Code.[68] The plaintiffs argued that the State put the pension systems "in a precarious financial condition" by failing to fully fund them.[69] The plaintiffs claimed that this impaired their pension benefits, violating the Illinois Constitution.[70] The circuit court dismissed the case on the pleadings, and the appellate court reversed.[71] The Illinois Supreme Court reversed the appellate court and affirmed the circuit court's decision to dismiss, holding that beneficiaries of the state retirement system have "neither a vested contractual nor constitutional right . . . to enforce the level of state contributions" contained in the Pension Code.[72]

Even if the plaintiffs in *People ex rel. Sklodowski* had succeeded, the remedy they sought would not have addressed the fundamental problem: the State does not currently have enough money to meet all of its obligations. The State must address the problem on a structural level.

C. Restructuring Issues

Any approach to restructuring must contend with several legal and political issues. First, Illinois's constitution prohibits decreasing or impairing pension benefits.[73] This provision has two parts: it creates "an enforceable contractual relationship," and it provides that benefits "shall not be diminished or impaired.[74] Considering the first part, the Illinois Supreme Court has explained that this was intended to "create a contractual right to benefits, while not freezing the politically sensitive area of pension financing."[75] The contractual right vests as soon as the employee enters the pension system.[76] The commentary to the constitutional provi-

66. CHRISSY A. MANCINI & RALPH MARTIRE, CTR. FOR TAX & BUDGET ACCOUNTABILITY, THE ILLINOIS PENSION FUNDING PROBLEM: WHY IT MATTERS 4 (2006), *available at* http://www.ctbaonline.org/New_Folder/Home%20Page/CTBA%20Final%20Pension%20Report%2011.13.06.pdf; *see also* Jones & Silverberg, *supra* note 1.

67. *See, e.g.*, People *ex rel*. Sklodowski v. State, 695 N.E.2d 374, 378 (Ill. 1998).

68. *Id*. at 375.

69. *Id*. at 378.

70. *Id*.

71. *Id*. at 374–75.

72. *Id*. at 379.

73. ILL. CONST. art. XIII, § 5.

74. *See id*.; Laurie Reynolds, *Legal Issues Surrounding Pension Reform*, *in* PUBLIC PENSION POLICY IN ILLINOIS: AN INTRODUCTION TO A CRUCIAL ISSUE 21, 22 (Univ. of Ill. Inst. of Gov't & Pub. Affairs ed., 2011).

75. *Sklodowski*, 695 N.E.2d at 379.

76. Hannigan v. Hoffmeister, 608 N.E.2d 396, 402 (Ill. App. Ct. 1992).

sion states that this relationship "is governed by the actual terms of the contract or pension."[77] While the State may not unilaterally reduce or impair vested benefits, an employee may agree to accept a reduction in benefits for consideration.[78] The notes from the Constitutional Convention of 1970, where delegates discussed the pension protection provision, stated that "[t]he word 'impaired' is meant to imply and to intend that if a pension fund would be on the verge of default or imminent bankruptcy, a group action could be taken to show that these rights should be preserved."[79] The exact scope of the "diminish or impair" part of the pension protection clause is not clear. When deciding if a change to benefits is an unconstitutional impairment, the Illinois Supreme Court appears to have drawn a line between accrued benefits and future benefits: accrued, vested benefits are protected, while the expectation of prospective benefits may not be.[80]

Taken as a whole, the pension protection clause admits of four possible interpretations.[81] One interpretation is that there is only a legally binding obligation between the employee and the pension system.[82] Under this interpretation, the State is not bound by the contract and is therefore not liable to pay for benefits if a pension system runs out of money.[83] As one scholar has noted though, this view is inconsistent with the Illinois Supreme Court's case law, notes from the Constitutional Convention of 1970, and the General Assembly's actions to fund the system.[84] A second and related interpretation of the pension protection clause holds that the Illinois Constitution does not limit the legislature's discretion to reduce benefits for current workers.[85] While the State is responsible for paying the benefits, its discretion with regard to how much it pays is essentially unlimited.[86] Of course, this view raises Contract Clause concerns in addition to pension clause concerns.[87]

The last two interpretations are more protective of pension benefits. In the third view, only vested rights to benefits that have already accrued are guaranteed by the constitution, but the State "may modify, decrease, or perhaps even terminate those benefits going forward."[88] Under this interpretation, the State could pass legislation that would divide pension benefits into tiers: one tier for rights that have accrued under the old re-

77. ILL. CONST. art. XIII, § 5, *in* ILL. COMP. STAT. ANN. (West 2006) (constitutional commentary by Robert A. Helman & Wayne W. Whalen).

78. Kraus v. Bd. of Trs. of Police Pension Fund, 390 N.E.2d 1281, 1293 (Ill. Ct. App. 1979).

79. IV RECORD OF PROCEEDINGS: SIXTH ILL. CONST. CONVENTION 2926 (July 21, 1970) [hereinafter CONVENTION PROCEEDINGS] (statement of Delegate Helen Kinney).

80. Reynolds, *supra* note 74, at 22–23.

81. *Id*. at 23.

82. *Id*.

83. *Id*.

84. *Id*.

85. *Id*.

86. *Id*.

87. *Id*.

88. *Id*. at 23–24.

gime and one tier for prospective rights of current and future employees which the State would presumably decrease.[89] This interpretation is consistent with the Illinois Supreme Court's distinction between accrued and prospective rights as well as "basic principles of contract law."[90] Finally, some have interpreted the pension protection clause to prohibit the State from modifying pension benefits at any time during an individual employment.[91] This interpretation would grant "immutable pension rights on the date [an employee] began to work for the State of Illinois."[92] While this may align most closely with an employee's expectations, it remains to be seen whether it is a constitutional requirement.[93] Indeed, one scholar has pointed out that it makes little sense to prohibit the State from modifying the University of Illinois's employees' pensions when the State has the power to simply shut down the University of Illinois.[94]

In addition, Illinois has a constitutional provision against passing laws impairing the obligation of contracts, the language of which mirrors the Contract Clause in the U.S. Constitution.[95] Applying this provision, the Illinois Supreme Court has held that "[l]egislation which substantially impairs contractual rights is unconstitutional unless justified as a reasonable exercise of the police power to secure an important public interest."[96] A reduction in State contributions may not be an impairment under the Illinois Constitution's contract clause.[97] Similarly, a prospective change to contractual rights may not be an impairment.[98]

Another legal hurdle to restructuring pension systems will be the State's status as a semi-sovereign body. At the federal level, a state is immune from suit under the Eleventh Amendment, which provides, "[t]he Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State."[99] In some instances, the U.S. Congress has the power to curtail states' rights. Of particular interest to debt restructuring is the provision in Article I of the U.S. Constitution giving Congress the power to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[100]

89. *Id*. at 24.
90. *Id*.
91. *Id*.
92. *Id*.
93. *Id*.
94. *Id*.
95. *Compare* U.S. CONST., art. I, § 10, *with* ILL CONST. art. I, § 16.
96. Stelzer v. Matthews Roofing Co., 511 N.E.2d 421, 423 (Ill. 1987).
97. *See* Letter from Lisa Madigan, Attorney Gen., State of Ill., to Judy Baar Topinka, Treasurer, State of Ill., on Constitutionality of General Assembly Reducing Scheduled State Contributions to the Retirement Systems (June 30, 2005), *available at* http://illinoisattorneygeneral.gov/opinions/2005/05-005.pdf.
98. *See* Reynolds, *supra* note 74, at 24.
99. U.S. CONST. amend. XI.
100. U.S. CONST. art. I, § 8, cl. 4.

There is no provision allowing a state to file for bankruptcy under the current Bankruptcy Code,[101] though a municipality can file under chapter 9 if it consents and state law allows it to do so.[102] Accordingly, some scholars and commentators have suggested amending the Bankruptcy Code to include an analogous provision for states.[103] Currently, chapter 9 prohibits a bankruptcy court from interfering with any "political or governmental powers," any of the debtor's "property or revenues," or "the debtor's use or enjoyment of any income-producing property," unless by the consent of the debtor or provided for by the plan.[104]

This means that a bankruptcy court cannot take over the sovereign powers of a municipality. This does not mean that a state can choose which parts of chapter 9 it will allow a municipality to follow.[105] Once the state allows a municipality to file for bankruptcy relief, and the municipality files, the state must take the bankruptcy provisions as a whole.[106] The interaction of the Eleventh Amendment, the Bankruptcy Clause, and the Supremacy Clause in the debt-restructuring context form two basic premises. First, a state is sovereign and therefore immune from suit unless it voluntarily submits to the jurisdiction of a federal tribunal. Second, once a state cedes its sovereign immunity for the purpose of debt restructuring, its conflicting laws will be preempted by the federal law. As the next Part will show, these two simple premises provide the foundation for powerful restructuring mechanisms.

III. ANALYSIS

Any approach to reforming or restructuring Illinois's pension liabilities must balance the legal and political constraints presented above. While this could conceivably have many permutations, this Part identifies three basic approaches that have been set forth to address states' debt problems and analyzes them in the context of Illinois's pension problems. Section A presents and analyzes a state bankruptcy approach based on chapter 9 of the Bankruptcy Code, modified to the specific needs of states as semi-sovereign entities. Section B discusses the other end of the spectrum: a political approach which involves pension reforms within the existing legal structure. Finally, Section C discusses a proposal for a "public pension funding authority" that lies in between the other two approaches.

101. 11 U.S.C. § 109 (2006).
102. *See id.* § 109(c); *id.* § 904.
103. *See infra* Part III.A.
104. 11 U.S.C. § 904.
105. *In re* City of Vallejo, 403 B.R. 72, 76 (Bankr. E.D. Cal. 2009).
106. The constitutional underpinning for this is a combination of the Bankruptcy Clause and the Supremacy Clause. U.S. CONST. art. I, § 8, cl. 4; *id.* art. VI, cl.2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.").

A. Bankruptcy Approach

A formal method of debt restructuring like bankruptcy is a natural choice in Illinois's current state of fiscal crisis. The Bankruptcy Code already contains a chapter for dealing with municipal bankruptcies: chapter 9.[107] Some academics and politicians have sought to amend the Code to include a chapter which would allow states to file for bankruptcy using chapter 9 as the model.[108] To infer how a new state bankruptcy provision might be received and used in Illinois, it is first necessary to look at the structure of chapter 9. Subsection 1 presents the basic structure of chapter 9 as it is currently used. In particular, it emphasizes how chapter 9 applies to a situation somewhat analogous to pensions: collective bargaining agreements between municipalities and municipal employees. Subsection 2 then analyzes how provisions similar to chapter 9 would operate at the state level using Illinois as an example. Lastly, Subsection 3 weighs the benefits and drawbacks of such an approach.

1. An Outline of Chapter 9

A state bankruptcy provision likely would follow the basic structure of chapter 9. Under chapter 9, a debtor must first consent to bankruptcy proceedings.[109] Then, the debtor must meet the following five requirements: it must (1) be a municipality, (2) that is authorized to file for bankruptcy under state law, (3) that is insolvent, and (4) that "desires to effect a plan to adjust [its] debts."[110] The fifth requirement consists of four alternatives. The municipality may be a debtor if it (A) "has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan . . . ," (B) "has negotiated in good faith with creditors and has failed" to reach an agreement with a majority of creditors in each class of claims it intends to impair, (C) cannot negotiate because to do so would be impracticable, or (D) "reasonably believes that a creditor may attempt to obtain" an avoidable preferential transfer.[111]

If a municipality meets these requirements and becomes a debtor under chapter 9, it must then "file a plan for the adjustment of [its]

107. 11 U.S.C. §§ 901–946.

108. *See State and Municipal Debt: The Coming Crisis?: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 7 (2011) (statement of David A. Skeel, Jr., Professor of Law, University of Pennsylvania Law School) [hereinafter *Skeel Testimony*], *available at* http://oversight.house.gov/wp-content/uploads/2012/01/Skeel_Testimony_2011.0209.pdf; David Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, WALL ST. J., Jan. 18, 2011, at A17; Mary Williams Walsh, *A Path Is Sought for States to Escape Debt Burdens*, N.Y. TIMES, Jan. 21, 2011, at A1; Alison Vekshin, *State Bankruptcy Weighed By Republicans Blocking Aid*, BLOOMBERG (Jan. 21, 2011, 4:18PM), http://www.bloomberg.com/news/2011-01-21/u-s-state-bankruptcy-weighed-by-house-republicans-blocking-aid.html.

109. 11 U.S.C. § 904.

110. *Id.* § 109(c)(1)–(4).

111. *Id.* § 109(c)(5).

debts."[112] To be confirmed, the plan must comply with the requisite provisions of the Bankruptcy Code, all payments under it must be disclosed and found to be reasonable, the debtor must legally be able to carry out all actions in the plan, all administrative expenses must be paid, any regulatory or electoral approval of any part of the plan under nonbankruptcy law must be obtained, and the plan must be in the best interests of creditors and must be feasible.[113] A confirmed plan is then binding on the debtor[114] and all creditors,[115] and the debtor is discharged of its debts.[116]

A traditional chapter 9 filing has important implications for employees of a municipal debtor. A significant number of public sector employees are union members working under a collective bargaining agreement.[117] Accordingly, employee wages and benefits governed by collective bargaining agreements (sometimes called memoranda of understanding in the context of public sector labor relations) will often be among the largest liabilities of a financially distressed municipality.[118] The issue in a successful municipal reorganization, then, will be the treatment of its collective bargaining agreements.

Though there is no direct appellate guidance, existing cases and commentary suggest that collective bargaining agreements can be rejected by a municipality in bankruptcy.[119] In a recent chapter 9 case, the city of Vallejo, California, sought to reject its collective bargaining agreements with unionized city employees.[120] The city based its argument on *NLRB v. Bildisco & Bildisco*, in which the Supreme Court held that unexpired collective bargaining agreements in a chapter 11 case were executory contracts that could be rejected under § 365 of the Bankruptcy Code.[121] Though that case was subsequently abrogated by the addition of § 1113 to chapter 11, no similar provision was incorporated into chapter 9.[122] In effect, chapter 9 cases are still in a *Bildisco* world, where executory contracts, including collective bargaining agreements, are subject to § 365. The bankruptcy court agreed that the city could reject an unexpired collective bargaining agreement if it showed that "(1) the collective

112. *Id.* § 941.

113. *Id.* § 943(b).

114. *Id.* § 944(a). A plan may be binding on a municipal debtor by the directive of § 106(a), which provides, "Notwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to . . . Section[] . . . 944." *Id.* § 106(a).

115. *Id*. § 944(a).

116. *Id.* § 944(b). The only exceptions to the discharge are where the plan provides otherwise or where a creditor "had neither notice nor actual knowledge" of the bankruptcy. *Id.* § 944(c).

117. *See* Ryan Preston Dahl, *Collective Bargaining Agreements and Chapter 9 Bankruptcy*, 81 AM. BANKR. L.J. 295, 306 (2007).

118. *Id*. at 296.

119. *See In re* City of Vallejo, 403 B.R. 72, 78 (Bankr. E.D. Cal. 2009); Dahl, *supra* note 117, at 321.

120. *Vallejo*, 403 B.R. at 74.

121. NLRB v. Bildisco & Bildisco, 465 U.S. 513, 521–22 (1984).

122. *Vallejo*, 403 B.R. at 77–78.

bargaining agreement burdens the estate; (2) after careful scrutiny, the equities balance in favor of contract rejection; and (3) 'reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution.'"[123]

2. State Bankruptcy

Of course, states currently are not allowed to file under chapter 9 or any other provision of the Bankruptcy Code. A look at how Illinois currently treats its own municipalities with respect to chapter 9 may be a helpful glimpse into the future. While several states have statutes providing direct authorization for municipalities to file chapter 9, Illinois has an "elaborate internal system[] designed to resolve serious debt crises without resort to the federal system."[124] This system is set forth in the Local Government Financial Planning and Supervision Act.[125]

The road to filing chapter 9 under the Local Government Financial Planning and Supervision Act is long and winding. First, this procedure is only available to "units of local government" with a population under 25,000.[126] Second, the municipality must be in a "fiscal emergency."[127] For purposes of the Illinois local government code, a "fiscal emergency" with respect to a local unit of government means one or more of the following conditions is met:

> (1) The existence of a continuing default in the payment of principal and interest on any debt obligation for more than 180 days.
>
> (2) The failure to make payment of over 20% of all payroll to employees of the unit of local government in the amounts and at the times required by law, ordinances, resolutions, or agreements, which failure of payment has continued for more than 30 days after such time for payment, unless at least 2/3 of the employees affected by such failure to pay, acting individually or by their duly authorized representative, consent in writing to an extension.
>
> (3) The insolvency of the unit of local government, being a financial condition such that the unit is (A) generally not paying its debts as they come due unless they are the subject of a bona fide dispute or (B) unable to pay its debts as they become due.[128]

If such a fiscal emergency exists or is anticipated within sixty days, then two-thirds of the governing body of a municipality may vote in favor of petitioning the governor to establish a "financial planning and supervi-

123. *Id*. at 78 (quoting *Bildisco*, 465 U.S. at 526).

124. *See* Daniel J. Freyberg, Comment, *Municipal Bankruptcy and Express State Authorization to Be a Chapter 9 Debtor: Current State Approaches to Municipal Insolvency—and What Will States Do Now?*, 23 OHIO N.U. L. REV. 1001, 1008–09 (1997).

125. 50 ILL. COMP. STAT. 320/1–14 (2010).

126. *Id.* § 320/3(d).

127. *Id.* § 320/4(b).

128. *Id.* § 320/3(b).

sion commission."[129] The petition must include "the conditions of fiscal emergency and a list of all [the municipality's] creditors."[130]

What happens next is within the Governor's discretion. Within sixty days of receiving the petition, the Governor will determine whether a fiscal emergency does indeed exist and, if so, will appoint a commission.[131] The Governor must "give reasonable notice and opportunity for a hearing" to all of the municipality's creditors before making this determination.[132] Upon making the determination, the Governor will issue an administrative order and the creditors will be stayed from enforcing their claims unless a reviewing court holds otherwise.[133] After a commission has been established, it has substantial powers to essentially effectuate a reorganization plan.[134] Only after determining that a financial plan will not work, the commission may "recommend" that the municipality file for chapter 9.[135] The complexity of the procedure supports the inference that the State will only allow a municipality to file chapter 9 as a last resort.

If the State is so reluctant to allow its municipalities to file chapter 9, perhaps it will not rush to the federal courthouse to solve its own debt problems. Even if Congress passed a new law allowing states to file bankruptcy, it can be assumed that, at the very least, Illinois would provide an arduous scheme for approving a bankruptcy petition. A state bankruptcy provision, like chapter 9, would certainly include a requirement that the state consent according to its own legislatively mandated procedures.[136] So, for example, "consent" for bankruptcy purposes could mean a two-thirds vote of the General Assembly and the Governor's consent. This process would lead to a lively debate, but it would only be the beginning of the difficulty.

After filing under chapter 9, the treatment of public pension obligations would largely depend on whether one treated the obligations as executory contracts under § 365.[137] The Bankruptcy Code does not define the term "executory contract," but the widely accepted definition is the "material breach" test, which defines an executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[138] In Illinois, public pensions are enforceable

129. *Id.* § 320/4(b).
130. *Id*.
131. *Id.* § 320/5(b)(1)–(2).
132. *Id.* § 320/5(b)(2).
133. *Id.* § 320/7.
134. *See id.* § 320/9.
135. *Id.* § 320/9(b)(4).
136. *Skeel Testimony*, *supra* note 108, at 6–7.
137. 11 U.S.C. § 365 (2006).
138. CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 805 (2d ed. 2009) (quoting Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973)).

contractual obligations.[139] For existing employees, however, pension benefits are based in part on length of service; an employee is not entitled to retire with a full pension after only one year of employment.[140] Hence, if the State filed bankruptcy, the contract for future pension benefits would be executory because the current employee has yet to perform (by fulfilling his or her length of service requirement), and the State has yet to perform (by paying out benefits).[141] The bankruptcy trustee would then have the power to reject the executory contract after weighing the factors set forth in *Bildisco*.[142]

Even with the potential power to reject cumbersome contractual obligations, states would be understandably reticent to file bankruptcy.[143] Yet state bankruptcy proposals have gained traction because some states "are in such dire financial straits that there is serious and legitimate doubt as to whether they can put their finances on more sustainable footing on their own."[144] At this stage, a provision for restructuring under the federal bankruptcy power has several benefits that cannot be obtained outside of bankruptcy.

3. Weighing the Benefits Against the Costs

Professor David Skeel suggests that a bankruptcy option would serve as a "fire department" for state fiscal crises.[145] Bankruptcy offers an orderly set of procedures uniquely designed to restructure debt, and it

139. ILL. CONST. art. XIII, § 5.

140. *See, e.g.*, 40 ILL. COMP. STAT. 5/14-107 (providing that SERS employees are entitled to a retirement annuity after having at least eight years of creditable service. Employees with at least eight years of service can retire with a full pension at age sixty, and any employee is entitled to a pension if the sum of the employee's age and years of creditable service equal eighty-five).

141. The case for modifying pension benefits already accrued (that is, the benefits associated with past service) is much weaker because employees have a property interest in these benefits. Miller v. Ret. Bd. of Policemen's Annuity & Benefit Fund of Chi., 771 N.E.2d 431, 437 (Ill. App. Ct. 2001). It is well settled that state law defines the scope of property rights in bankruptcy. *See* Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.").

142. NLRB v. Bildisco & Bildisco, 465 U.S. 513, 526 (1984). Normally the bankruptcy trustee's decision to accept or reject an executory contract is reviewed under the deferential "business judgment" standard. *See id*. at 523. The *Bildisco* court agreed that collective bargaining agreements should be judged on a stricter standard than the trustee or debtor-in-possession's business judgment. *Id*. at 526. In the context of collective bargaining agreements, the Court opted for a higher standard that requires a bankruptcy court to "make a reasoned finding on the record why it has determined that rejection should be permitted" while giving due consideration to the "interests of the affected parties—the debtor, creditors, and employees." *Id*. at 527; *see also supra* note 126 and accompanying text.

143. Christine O. Gregoire et al., *NGA/NCSL State Bankruptcy Letter*, NAT'L CONF. STATE LEGISLATURES (Feb. 3, 2011), http://www.ncsl.org/issues-research/banking/nga-ncsl-bankruptcy-letter.aspx.

144. *Skeel Testimony*, *supra* note 108, at 1.

145. *Id*. at 2 ("Some have argued that a bankruptcy option is not necessary, because nearly all of the states will be able to muddle their way through their fiscal predicament. This is like saying there's no need for a fire department because most homeowners never have fires in their houses and if one starts they can probably stop it in time. This is true, but we still need fire departments for the rare case where a fire burns out of control.").

deals directly with collective action problems while considering the relative rights and positions of all creditors.[146] Professor Skeel notes the two primary benefits of a bankruptcy option: it preempts state law, allowing states to restructure debt obligations that would otherwise be difficult or impossible to address; and it ensures a fair distribution of sacrifices among all stakeholders.[147]

A state bankruptcy law would use Congress's power to make "uniform Laws on the subject of Bankruptcies" to overcome state law obstacles.[148] Public employee contracts generally are difficult to renegotiate.[149] In a bankruptcy proceeding, however, the parties have much more incentive to renegotiate a deal because the court may simply terminate the contract.[150] For pensions specifically, any money the state has set aside to pay its obligations would not be part of the bankruptcy distribution; the employees in the pension systems would have a property interest in those funds subject to the Takings Clause.[151] The primary benefit of bankruptcy with regard to pensions is "the authority to restructure the state's obligations to existing employees to make its pension promises more realistic and sustainable."[152]

A second benefit of bankruptcy is that all creditors share in the sacrifice of the restructuring; the burden does not fall disproportionately on a single constituency.[153] This is significant with regard to general obligation bonds.[154] In many cases, the terms of general obligation bonds cannot be changed, leaving states with a difficult choice: the state must continue to service its debt in full while making painful cuts elsewhere, or it must default on its bonds.[155] Bankruptcy offers a way to bring bondholders to the table along with public employees and beneficiaries of state services, ensuring a fairer distribution of cuts.[156]

On the other hand, there are strong arguments that bankruptcy law is a wrong-headed approach. The three traditional rationales for a bankruptcy law are (1) preventing collective action problems among creditors to ensure an orderly distribution of limited assets, (2) restructuring to

146. *See id*. at 3.
147. *Id*.
148. U.S. CONST. art I, § 8, cl. 4.
149. *Skeel Testimony*, *supra* note 108, at 4; *see infra* Part III.B.
150. *Skeel Testimony*, *supra* note 108, at 4.
151. U.S. CONST, amend. V; *Skeel Testimony*, *supra* note 108, at 4. The Takings Clause provides that private property shall not be taken for public use without just compensation. U.S. CONST., amend. V. The argument is that once funds have been set aside for pensions, the beneficiaries have acquired a property right in those funds. *See Skeel Testimony*, *supra* note 108, at 4. This property right cannot be extinguished without just compensation to the beneficiaries. *Id.* Therefore, money committed to pension funds would only be available for pensions; it would not become part of the bankruptcy estate. *See id.*
152. *Skeel Testimony*, *supra* note 108, at 4.
153. *Id*. at 5.
154. *Id*.
155. *Id*.
156. *Id*.

preserve going concern value, and (3) providing a fresh start for the debtor.[157] The last rationale—a fresh start—is inapplicable outside the context of bankruptcy. Professor Levitin argues that the first two rationales do not make sense when applied to states.[158]

First, creditors' collective action is not a concern because a state, unlike a firm, has nearly unlimited power to raise revenue and cut services.[159] It does not need to worry about a "race to the courthouse" because it would be protected by sovereign immunity.[160] Second, "going concern value" is meaningless in the context of a state government because going concern value is defined relative to liquidation value, and a state cannot be liquidated or sold.[161] In addition, Professor Levitin argues that a state can never be "insolvent in any meaningful sense" because of its ability to raise revenue and cut expenses.[162] Finally, restructuring to preserve the "going concern value" of a state does not make sense because restructuring is predicated on three principles: feasibility, best interests (guaranteeing that creditors will receive at least as much as they would in liquidation), and good faith.[163] But "feasibility" of a state reorganization "depends on state political will as much as general economic factors."[164] And as stated above, states have no liquidation value so there is no baseline to determine "best interests."[165] Lastly, Professor Levitin posits that "good faith is questionable given the motivation for state bankruptcy proposals, which are conceived as a method for enabling states to reject collective bargaining agreements and pension obligations . . . ."[166]

Setting aside the question of good faith momentarily, it is unclear whether state bankruptcy would be able to address pension debt effectively. There are several reasons for this. First, few state governors and legislatures are in favor of a state bankruptcy provision in general.[167] On top of that, pension benefits—and the rights of public sector employees more broadly—are contentious political issues, so it is far from certain that any federal legislation would pass without some protection for

157. Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1422 (2012). "Going concern value" is the notion that the assets of an enterprise are worth more when put to productive use as part of an ongoing business than they are in liquidation; in other words, an enterprise "is worth more alive than dead." TABB, *supra* note 138, at 7.

158. Levitin, *supra* note 157, at 1422.

159. *Id.* at 1433–34.

160. *Id*. at 1434.

161. *Id*.

162. *Id.* at 1434–35.

163. *Id*. at 1435–38.

164. *Id*. at 1438.

165. *Id*.

166. *Id*.

167. Gregoire et al., *supra* note 148 (explaining that the National Governors Association and the National Conference of State Legislatures "do not support proposals to provide states with bankruptcy protection").

workers.[168] Even if a federal law were enacted with substantially similar terms to chapter 9, *In re City of Vallejo* is a controversial decision as a matter of legal doctrine.[169] Lastly, Professor Skeel, a proponent of state bankruptcy, recognizes that "[e]ven in bankruptcy, it is highly unlikely that any state would severely retrench on its pension promises, even if this were legally permissible."[170] Skeel then correctly points out, however, that "even a relatively modest restructuring of the state's pension obligations could make the longterm prognosis for its pensions far better."[171]

Because state bankruptcy would not serve any traditional bankruptcy purposes, the argument goes, it must be used to some other end. But bankruptcy is not—and according to Professor Levitin it should not be—a political tool.[172] For political problems, there are political solutions.

B. Political Approach

To those opposed to a bankruptcy approach to state debt crises, the problem is fundamentally a political one. For political problems, legal-financial solutions such as bankruptcy are inherently inappropriate.[173] This Section focuses on the policy options available to legislators under the current legal regime. Subsection 1 lays out the argument in favor of a political solution as opposed to a formal restructuring regime. Subsection 2 analyzes the current options for pension reform under Illinois law. Finally, Subsection 3 presents some of the shortcomings of such an approach.

1. Argument in Favor of a Political Solution

For advocates of a political solution, the current level of crushing state debt—including pension liabilities—is a result of structural political problems.[174] In this view, debt restructuring is a solution to a different problem. In response to calls for a state bankruptcy option, Professor

168. *See* Schwarcz, *supra* note 64, at 343. States would not be allowed to "superimpose[]" their labor laws or other protections of public sector employees on a federal bankruptcy law. *In re* City of Vallejo, 403 B.R. 72, 76–77 (Bankr. E.D. Cal. 2009). If a state opts for bankruptcy, then the federal bankruptcy law would preempt all conflicting state law under the Supremacy Clause and the Bankruptcy Clause. *See* U.S. CONST. art. I, § 8, cl. 4; U.S. CONST. art. VI, cl. 2; *In re City of Vallejo*, 403 B.R. at 77.

169. Schwarcz, *supra* note 64, at 343–44 & n.126 ("The *In re City of Vallejo* opinions do not adequately address how their holdings square with 11 U.S.C. § 1113(f), which provides that '[n]o provision of this title [11] shall be construed to permit a [party in bankruptcy] to unilaterally terminate or alter any provisions of a collective bargaining agreement prior to compliance with the provisions of this section.'" (alterations in original)). Professor Schwarcz then notes that "this title" refers to title 11, which contains the entire bankruptcy code, including chapter 9. *Id*. at 344 n.126.

170. *Skeel Testimony*, *supra* note 108, at 4.

171. *Id*.

172. Levitin, *supra* note 157, at 1446–50.

173. *Id*. at 1403.

174. *Id*. at 1403–04.

Adam Levitin argues that state budget crises arise from two unique aspects of states that bankruptcy is ill-equipped to address: "fiscal federalism" and state political economy.[175]

First, Professor Levitin explains that fiscal federalism—the relationship between the budgets of state and federal governments—is "hardwired to create cyclical state financial distress."[176] States are mandated by the federal government to provide health care, disability, and unemployment programs to their citizens, but these mandates are either unfunded or only partially funded.[177] Furthermore, Illinois has a balanced budget provision in its constitution which prohibits unfettered spending to satisfy the federal mandate.[178] As Levitin points out, one way states have paid for the mandated programs, while circumventing these balanced budget requirements, is by taking money from pension funds.[179] The only ways to eliminate this structural problem are to eliminate unfunded mandates, give states borrowing power commensurate with their obligations, or eliminate balanced-budget requirements.[180]

Second, state political economy leads to structural budget crises. Professor Levitin argues that state politics are susceptible to moral hazard because "[s]tate legislatures and governors do not bear the full cost of their budgetary decisions."[181] Though fiscal federalism imposes considerable budgetary challenges, which often leave pensions out in the cold,[182] this problem is exacerbated by poor political decisions.[183] Cutting services or raising taxes are rarely appealing choices, but they are within the legislature's power.[184] In times of surplus, politicians can choose between saving for future fiscal shocks or returning the surplus to citizens in the form of tax cuts or increased investment in government programs.[185] The short-term benefits of the latter choice to both politicians and constituents are clear.

Pensions are particularly sensitive to this cycle. When times are good and the stock market is up, pension funding looks strong.[186] In a downturn, however, funding shortfalls are more pronounced, and at the same time, the state is less able to appropriate funds.[187] Electoral discipline is an imperfect remedy in such situations because it is not instantaneous, and fiscal policy is only one of many issues that voters consider

175. *Id*. at 1406.
176. *Id*. at 1406–07.
177. *Id*. at 1408.
178. *See* ILL. CONST. art. VIII, § 2; *see also id.* art. IX, § 9 (limiting the amount of debt the State may incur).
179. Levitin, *supra* note 157, at 1414–16.
180. *Id*. at 1419.
181. *Id*.
182. *See supra* notes 177–81 and accompanying text.
183. Levitin, *supra* note 157, at 1419.
184. *Id*. at 1419–20.
185. *Id*. at 1427–28.
186. *Id*. at 1427.
187. *Id*.

when choosing between their often limited options.[188] The political problems are immense, but there are some options for dealing with the problem in this difficult climate.

2. Political Reform Under Current Illinois Law

With the structural difficulties of state budgets and sheer size of its unfunded liability, Illinois's toolbox under current law is limited to a set of politically unpopular choices. Some combination of the following moves would be necessary to reduce the funding gap: the State could raise revenues by increasing taxes,[189] cut spending on other government programs and services,[190] borrow more money,[191] or shift from a defined-benefit to a defined-contribution system.[192] Additional measures include lowering or eliminating cost-of-living adjustments, increasing contributions by employers, increasing contributions by employees, or raising the retirement age.[193] All of these are difficult choices, and as discussed below some may also be unconstitutional. In a sense, the lack of political will to make these choices is exactly what led to the problem in the first place.

Other states facing pension crises have found a politically feasible mix of these measures. For example, Rhode Island recently enacted sweeping reforms to address its $7 billion in unfunded pension liabilities.[194] Shortly before passing these reforms, its pensions had ranked among the worst funded in the nation relative to the size of its total liability.[195] Current Rhode Island public employees retain all of the benefits they accrued under the old plan until June 30, 2012, but then they move to a hybrid plan that is partly defined-benefit, partly defined-contribution.[196] In addition, the new plan suspends regular cost-of-living adjustments to retirees' benefits until the pension systems are eighty percent funded, substituting a standard adjustment every five years in the interim.[197] At the same time, the plan increases the retirement age of ex-

188. *Id*. at 1426–27.

189. Darren Lubotsky & David Merriman, *A Primer on Pensions and Options for Reform*, *in* PUBLIC PENSION POLICY IN ILLINOIS, *supra* note 74, at 6, 16–17.

190. *Id*. Although, as Professor Levitin points out, the ability to make cuts is limited to some extent by federal mandates to provide certain services. *See supra* text accompanying notes 179–83.

191. Lubotsky & Merriman, *supra* note 189, at 16–18.

192. *Id*. at 16, 18–19.

193. Monique Garcia, *Quinn Offers Details on Pension, Medicaid Cost Cutting*, CHI. TRIB. (Feb. 7, 2012, 4:54PM), http://www.chicagotribune.com/news/politics/clout/chi-quinn-offers-details-on-pension-medicaid-cost-cutting-20120207,0,7220519.story.

194. *See* Rhode Island Retirement Security Act of 2011, S. 1111, 2011 Sess. (R.I. 2011) [hereinafter RIRSA]; R.I. GEN. ASSEMB. RET. SEC. LEGIS., EXECUTIVE SUMMARY OF RHODE ISLAND RETIREMENT SECURITY ACT OF 2011, at 1 (2011) [hereinafter RIRSA Executive Summary], *available at* http://www.pensionreformri.com/resources/ReportwithGRSAppendix.pdf.

195. *See* THE WIDENING GAP, *supra* note 7, at 3.

196. RIRSA EXECUTIVE SUMMARY, *supra* note 194, at 5. This provision excludes the pensions of public safety workers and judges. *Id*.

197. *Id*.

isting state employees and re-amortizes the payment schedule over twenty-five years.[198] An actuarial analysis of the law predicts that the reforms will immediately lower the unfunded liability by $3 billion.[199]

There is some concrete evidence that the Illinois legislature is considering similar measures. First, the General Assembly reduced benefits for employees of certain state retirement systems who are hired after January 1, 2011.[200] Although this provision will limit the growth of future pension liabilities, it will not help the State pay for its existing liabilities.[201] A more significant change would reduce the prospective benefits for existing state employees. One recent pension reform bill, House Bill 3411, proposes to do just that.[202]

House Bill 3411 would create a three-tiered system. Members of TRS and SURS hired on or after January 1, 2014, would form Tier 3,[203] and they would participate in a hybrid defined-benefit and defined-contribution plan.[204] Tier 2 would consist of employees who entered the system on or after January 1, 2011, but before January 1, 2014, and they would have the choice to either join Tier 3 or to keep their current benefits,[205] which already include an increased retirement age, limited COLA, and lower salary upon which their annuity is calculated.[206] The most significant changes under House Bill 3411 would affect Tier 1, which consists of all public employees hired before January 1, 2011.[207] Tier 1 participants would be required to make additional contributions of one percent of their salary for fiscal year 2014 and two percent of salary thereafter.[208] Their COLA would capped and delayed until the earlier of age sixty-seven or five years after retirement.[209] Their pensionable salary would be capped at the greater of the Social Security wage base or the participant's salary on the effective date of the legislation.[210] Finally, Tier 1 partici-

198. *See id.* at 5–6.

199. Letter from Joseph P. Newton et al., Gabriel Roeder Smith & Co. to Helio Melo & Daniel DePonte, Chairmen, R.I. House Fin. Comm. 1 (Nov. 14, 2011) [hereinafter Actuarial Analysis of RIRSA], *available at* http://www.pensionreformri.com/resources/ReportwithGRSAppendix.pdf.

200. 40 ILL. COMP. STAT. 5/1-160 (2010).

201. ERIC M. MADIAR, ILL. SENATE DEMOCRATIC CAUCUS, IS WELCHING ON PUBLIC PENSION PROMISES AN OPTION FOR ILLINOIS?: AN ANALYSIS OF ARTICLE XIII, SECTION 5 OF THE ILLINOIS CONSTITUTION 2 (2011), *available at* http://www.senatedem.ilga.gov/phocadownload/PDF/Pension Docs/madiarrevisedpensionclausearticle.pdf.

202. The bill in question is Senate Bill 512. *See* Kristen McQueary & David Greising, *Action to Fund Illinois Pension System Remains Uncertain*, N.Y. TIMES, Nov. 5, 2011, www.nytimes.com/2011/11/06/us/action-to-fund-pension-system-remains-uncertain.html.

203. H.B. 3411, 98th Gen. Assemb. §§ 15-107.3, 16-106.6 (Ill. 2013) (pp. 106, 167 of pdf), *available at* http://www.ilga.gov/legislation/BillStatus.asp?DocTypeID=HB&DocNum=3411&GAID=12&SessionID=85&LegID=75280.

204. H.B. 3411 §§ 15-158.5, 16-152.8.

205. H.B. 3411 §§ 15-107.3, 16-106.6.

206. *See supra* note 200 (noting that 40 ILL. COMP. STAT. 5/1-160 reduced benefits for new hires).

207. *See* H.B. 3411 § 2-105.1.

208. *Id.* § 2-126(a-5).

209. *Id.* § 2-119.1(a-2).

210. *Id.* § 2-108.

pants would see a phased-in increase to their retirement age.[211] It is these proposed unilateral changes to existing employees' benefits that have raised questions under the Pension Clause.

Opponents of prospective adjustments to the benefits of current state employees have argued that such measures would be unconstitutional.[212] Most prominently, Eric Madiar, Chief Legal Counsel to Illinois Senate President John Cullerton, argued that any prospective reductions in pension benefits without legal consideration would be an unconstitutional diminishment of benefits.[213] Meanwhile, a prospective reduction in benefits has many supporters, including members of the media and civic organizations.[214] Each side claims the language, legislative history, and case law of the pension clause supports its desired result.[215] A brief discussion of this polemic is necessary to understand the scope of possibilities available to the State under the current political regime.

a. Two Views of the Text and History of the Pension Clause

In Madiar's view, the pension clause in the Illinois Constitution unambiguously prohibits a prospective modification of benefits.[216] The pension clause 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."[217] Although the pension clause does not indicate when a contractual relationship arises, in Madiar's view "common sense and logic nonetheless dictate that an employee receives these rights upon becoming a member of a pension system."[218] Moreover, Madiar argues that the language of the clause is absolute: it prohibits "*unilateral* reduction or elimination" of pension benefits.[219]

Madiar claims the context and legislative history of the pension clause support this result. When delegates to the 1970 Constitutional Convention were considering the pension clause, Illinois courts distinguished between public-sector employees who participated in mandatory

211. *Id.* § 2-119(a-5).

212. *See, e.g.*, MADIAR, *supra* note 201, at 2; Memorandum from Gino DiVito & John Fitzgerald on Diminution of Pension Benefits for Current Employees to Pat Quinn, Governor, State of Ill., & Theodore T. Chung, Gen. Counsel Office of the Governor (May 5, 2010) [hereinafter DiVito Memo], *available at* http://www.senatedem.ilga.gov/phocadownload/PDF/Attachments/divitomemo-05-05-10.pdf.

213. *See* MADIAR, *supra* note 201, at 2.

214. *See, e.g.*, FY2013 BUDGET ROADMAP, *supra* note 3, at 43; Editorial, *'Pension Reform First*,' CHI. TRIB., Oct. 16, 2011, § 1, at 26.

215. MADIAR, *supra* note 201, at 2; Memorandum from Sidley Austin LLP on Illinois' Authority to Reduce the Pension Benefits that Current Employees Will Earn from Future Service (Apr. 27, 2010) [hereinafter Sidley Memo], *available at* http://www.senatedem.ilga.gov/images/pensions/C/Sidley%20Memo%2004-27-10.pdf.

216. MADIAR, *supra* note 201, at 2.

217. ILL. CONST. art. XIII, § 5.

218. MADIAR, *supra* note 201, at 3.

219. *Id*. at 4.

pension plans and those who participated in optional pension plans.[220] If a pension was optional, the employee had an enforceable contract with vested rights at the time she chose to participate.[221] If a pension was mandatory, then courts treated it as a "bounty" or "gratuity" that could be modified or abolished at the legislature's whim.[222] Amid this legal uncertainty, pension underfunding was also a concern, and public sector workers pushed hard for constitutional protection of their benefits.[223]

The language they sought mirrored the pension clause in the New York Constitution.[224] New York courts interpreting this provision have consistently held that the clause "fix[es] the rights of the employee at the time he became a member of the system."[225] Indeed, Delegate Henry Green, one of the cosponsors of Illinois's pension clause at the Convention, stated that "[o]ur language is that language that is in the New York Constitution which was adopted in 1938, really under a similar circumstance."[226] Another cosponsor, Delegate Helen Kinney, affirmed that the language came from the New York Constitution and that "[t]he thrust of it is that people who do accept employment will not find at a future time that they are not entitled to the benefits they thought they were when they accepted the employment."[227]

After some delegates expressed concern about the possible scope of the clause, Delegate Kinney clarified:

> To establish the record as to intent, I should just like to briefly say that the word "enforceable" is meant to provide that the rights so established shall be subject to judicial proceedings and can be enforced through court action. The word "impaired" is meant to imply and to intend that if a pension fund would be on the verge of default or imminent bankruptcy, a group action could be taken to show that these rights should be preserved.[228]

Both Delegate Green and Delegate Kinney reassured opponents of the provision that prohibiting "diminishment" of benefits did not include raising benefits in real dollars to account for cost-of-living and inflation, and "impairment" did not include maintaining a particular funding lev-

220. *Id*. at 5–6.

221. *Id*. at 6.

222. *Id*. at 6–7. Before the 1970 Constitution, only two of the State's seventeen pension systems—the General Assembly Retirement System and the Judicial Retirement System—were optional. *Id*. at 7.

223. *Id*. at 10; *see also* CONVENTION PROCEEDINGS, *supra* note 79, at 2925 (statement of Delegate Henry Green) (noting that in the twenty-two years preceding the Convention "the unfunded accrued liabilities of these pension plans in Illinois have increased from about $359,000,000 to almost $2,500,000,000, and the unfunded accrued liabilities are real and are not theoretical obligations based upon service already rendered").

224. MADIAR, *supra* note 201, at 7–9 (discussing N.Y. CONST. art. V, § 7).

225. Birnbaum v. N.Y. State Teachers Ret. Sys., 152 N.E.2d 241, 245 (N.Y. 1958); *accord* Ballentine v. Koch, 674 N.E.2d 292, 294 (N.Y. 1996).

226. CONVENTION PROCEEDINGS, *supra* note 79, at 2925 (statement of Delegate Harry Green).

227. *Id*. at 2931 (statement of Delegate Helen Kinney).

228. *Id*. at 2926.

el.[229] Finally, both cosponsors agreed that "it would be quite fair if a person undertook employment under a statute that provided for a contingency for lowering the benefits at some future time," as it would be a part of the contract the employee accepted upon entering the system.[230]

After the Convention approved the language of the pension clause, the Pension Laws Commission, a body created by the General Assembly to review legislation pertaining to the state pension systems, attempted to amend the provision.[231] The Commission sought to add language allowing the General Assembly to make reasonable modifications to benefits and employee contributions if they were necessary to maintain the fiscal health of the pension system.[232] Delegate Green refused to introduce the amendment to the Convention.[233] Another member of the Pension Laws Commission sought to have a statement read into the Convention record saying that the Convention did not intend to prevent the leglegislature from making reasonable modifications necessary to ensure the financial stability of the funds.[234] This request also failed.[235] From this, Madiar infers that the pension clause does not allow the General Assembly to make reasonable modifications of benefits because the Convention had a clear opportunity to provide such a power, and it declined.[236]

In a memorandum to the Civic Committee of the Commercial Club of Chicago, the law firm Sidley Austin (Sidley) took a contrary view of the text and legislative history of the pension clause.[237] Sidley argued that the text of the pension clause does not unambiguously entitle public employees to have their pension benefits calculated using the same formula that was in place the day they entered the pension system.[238] Under the pension clause, Sidley argued, an "enforceable contractual relationship" simply means that "employees have a contractual right not to be excluded from membership in the system;" the clause "says nothing about the way in which benefits earned by future employment are to be deter-

229. *See id*. at 2931–32.
230. *Id*. at 2931.
231. MADIAR, *supra* note 201, at 22–23.
232. *Id*. at 22–23.
233. *Id*. at 23.
234. *Id*. at 23–24.
235. *Id*. at 24.
236. *Id*.
237. Sidley Memo, *supra* note 215. As noted above, the Sidley Memo was written on April 27, 2010. A month earlier, Sidley wrote a four-page analysis of the pension clause for the Civic Committee of the Commercial Club advocating a similar position. *See* SIDLEY AUSTIN LLP, PENSION REFORM ANALYSIS (Mar. 2010), *available at* http://www.senatedem.ilga.gov/images/pensions/C/Sidley PensionReformAnalysis%2003-10.pdf. In response, former Illinois Appellate Justice Gino DiVito and John Fitzgerald wrote to Governor Pat Quinn espousing a position substantially similar to Madiar's. *See* MADIAR, *supra* note 201, at 44; DiVito Memo, *supra* note 212. The Illinois State Bar Association endorsed Justice DiVito's position. *See* Statement of John G. O'Brien, President, Ill. State Bar Ass'n (Apr. 14, 2010), *available at* http://www.senatedem.ilga.gov/images/pensions/C/ISBA%20Pension%20Statement%2004-14-2010.pdf. The Sidley Memo responds to Justice DiVito's critiques. Sidley Memo, *supra*, at 1.
238. Sidley Memo, *supra* note 215, at 6.

mined."[239] Likewise, the prohibition against diminishment or impairment of pension benefits does not guarantee a particular formula or level of benefits.[240] In Sidley's view, "[t]he 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)."[241] Thus, by its plain language, the pension clause only prevents the General Assembly from retroactively diminishing or impairing benefits that have already accrued.[242]

Sidley claims that this view of the plain language is unambiguous, and the view espoused by Madiar and others does not make sense.[243] In that view, an employee has "the right to have future pension benefits calculated under the formula that was in effect on the employee's first day."[244] Sidley, however, argues that "[t]he 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."[245] Even if the pension clause is ambiguous, the ambiguity should be resolved in favor of the interpretation that does not "limit or impair the ability of the Government to deliver essential services in the manner believed most efficient and appropriate."[246] Given the depth of the State's fiscal crises, an interpretation of the pension clause providing broader protection would prevent the State from effectively addressing the issues it now faces.[247]

Sidley argues that this result is supported by the legislative history.[248] In Sidley's view, the delegates did not issue any clear pronouncement on whether prospective modifications would be allowed.[249] Instead, the delegates were concerned about three issues, none of which are explicitly relevant to modifying benefits.[250] First, the 1970 Constitution sought to give municipalities broad home-rule powers, and public-sector employees were concerned that local governments would be free to repudiate pension obligations.[251] Second, the delegates were concerned that the pension clause would impose a minimum-funding obligation on the State, constraining its budget-making powers.[252] Third, the delegates were concerned that the pension clause included automatic cost-of-living increases for pension benefits.[253] Sidley argues that the floor statements, including

239. *Id*.
240. *Id*. at 6–7.
241. *Id*.
242. *Id*. at 7.
243. *See id*.
244. *Id*.
245. *Id*.
246. *Id*.
247. *See id*.
248. *Id*. at 8–9.
249. *Id*.
250. *See id*. at 9.
251. *Id*.
252. *Id*. at 9–12.
253. *Id*. at 12–13.

those of Delegates Green and Kinney, were pointed at these problems, and not the issue of prospective modifications of benefits.[254] Illinois courts have considered the same evidence in a few cases, but the results have been similarly inconclusive.

b. A Review of Illinois Case Law on the Pension Clause

The Illinois Supreme Court first considered the scope of the pension clause in *Peters v. City of Springfield.*[255] In *Peters*, three firefighters sued their municipal employer, claiming that a city ordinance lowering the mandatory retirement age from sixty-three to sixty was an unconstitutional diminishment of their pensions.[256] Under the terms of the Pension Code at that time, working fewer years meant receiving a lower monthly pension payment in retirement.[257] Under a mandatory earlier retirement age, the plaintiffs stood to receive a lower percentage of their salary as a pension benefit.[258] The Illinois Supreme Court held that the ordinance did not run afoul of the pension clause, explaining

> the purpose and the intent of the constitutional provision was to insure that pension rights of public employees which had been earned should not be "diminished or impaired" but that it was not intended, and did not serve, to prevent the defendant City from reducing the maximum retirement age, even though the reduction might affect the pensions which plaintiffs would ultimately have received.[259]

The *Peters* court noted that "municipal employment is not static and a number of factors might require that a public position be abolished, its functions changed, or the terms of employment modified."[260] The scope of the holding in *Peters* is unclear: Does it allow any prospective change to pension benefits or only changes to employment that have an indirect effect on pensions? Subsequent Illinois cases have not definitively decided the issue, though a few decisions are applicable.

The next case came five years later when the Illinois Appellate Court considered whether the pension clause entitled an employee "to receive a pension based on a section of the Pension Code in effect at the time of his entry into the pension system . . . although the section was subsequently repealed and replaced prior to the time plaintiff retired or became eligible to retire."[261] In *Kraus v. Board of Trustees of the Police Pension Fund of Niles, Illinois*, the plaintiff was a policeman who joined the force in 1956 and paid into his local pension fund until 1967, when he

254. *Id*. at 9–14.
255. Peters v. City of Springfield, 311 N.E.2d 107 (Ill. 1974).
256. *Id*. at 111.
257. *Id*.
258. *Id*.
259. *Id*. at 112.
260. *Id*.
261. Kraus v. Bd. of Trs. of the Police Pension Fund of Niles, 390 N.E.2d 1281, 1283 (Ill. App. Ct. 1979).

went on disability leave.[262] Under a provision of the Pension Code in force at the time the pension clause was ratified, the plaintiff could retire with a full retirement pension in lieu of his disability pension, but this provision was repealed and replaced before the plaintiff was eligible to retire.[263] The court held that applying the new provision to the plaintiff was an unconstitutional diminishment of his benefits because the pension clause "prohibits legislative action which directly diminishes the benefits to be received by those who became members of the pension system prior to the enactment of the legislation, though they are not yet eligible to retire."[264] In dicta, the court noted that "[l]egislative action directed toward another aim, but which has an incidental effect on the pensions which employees would ultimately receive, is not prohibited."[265]

The Illinois Supreme Court took up a similar issue in *Felt v. Board of Trustees of the Judges Retirement System*.[266] In *Felt*, the plaintiffs sued their retirement system claiming that an amendment to the Pension Code that changed the salary base used to calculate the amount of the plaintiffs' retirement annuity was unconstitutional.[267] The statutory provision in place at the time the judges entered the system based the amount of their pension annuity on the salary they received on their last day of service.[268] The new provision based the annuity on the average salary over the judges' final year of service.[269] The plaintiffs applied for an annuity based on their final day of service because they had received a salary increase in the year preceding their retirement.[270] Thus, their annuity would have been higher under the old law than under the new law.[271] Relying on statements by the Constitutional Convention delegates and cases interpreting the identical provision in the New York Constitution, the court held that the legislative change as applied to the plaintiffs violated both the pension clause and the Contracts Clause.[272]

The defendants in *Felt* urged the court to follow other jurisdictions with pension clauses in their constitutions that permit reductions in retirement benefits.[273] The court declined, explaining that to do so would "ignore the plain language of the Constitution of Illinois, reject the New York decisions on the constitutional provision which was the model for section 5 of article XIII, and overrule this court's decision in [a pre-1970

262. *Id*.
263. *Id*.
264. *Id*. at 1292–93.
265. *Id*. at 1293.
266. Felt v. Bd. of Trs. of the Judges Ret. Sys., 481 N.E.2d 698 (Ill. 1985).
267. *Id*. at 699.
268. *Id*.
269. *Id*.
270. *Id*.
271. *Id*.
272. *Id*. at 700–01.
273. *Id*.

case]."[274] The court determined that, unlike Illinois and New York, the other states' constitutional provisions have "restrictive language that has permitted modifications in benefits."[275]

The last Illinois Supreme Court decision on the modification of benefits came in 1987, two years after *Felt*. In *Buddell v. Board of Trustees of the State University Retirement System*,[276] the court considered whether an amendment to the Pension Code that eliminated an employee's right to purchase military service credit was unconstitutional under the pension clause.[277] In finding that the new law violated the pension clause, the court adopted the reasoning of the Illinois Appellate Court in *Kraus*, which held that an employee is "entitled to receive a pension based on the relevant section of the Pension Code in effect at the time that article XIII, section 5, of the 1970 Illinois Constitution became effective."[278] The court distinguished *Peters* on the fact that the provision regarding the plaintiffs' retirement age in that case was contained in the Municipal Code, not the Pension Code.[279] The *Buddell* court held that, where the plaintiff had rights to purchase military service credit toward his pension benefits when he became a member of the system, "the legislature cannot divest [him] of these rights."[280]

Madiar argues that the Illinois Supreme Court has been clear: the pension clause fixes employees' rights at the time they become members of the pension system.[281] Thus, the pension clause creates an enforceable contractual relationship, the terms of which are found in the Pension Code at the time the employee becomes a member of the system.[282] This relationship is "subject to modification through contract principles," and it does not include the terms or conditions of employment more generally, unless those conditions are set forth in the Pension Code.[283] As examples of employment conditions not contemplated by the pension clause, Madiar points to a mandatory retirement age, work hours, and salaries.[284] Any of these may be modified if "the change stems from an independent reason," regardless of their effect on pension benefits.[285]

274. *Id*. at 702.
275. *Id*.
276. Buddell v. Bd. of Trs. State Univ. Ret. Sys. of Ill., 514 N.E.2d 184 (Ill. 1987).
277. *Id*. at 186.
278. *Id*. at 188.
279. *Id*. at 186.
280. *Id*. at 188.
281. MADIAR, *supra* note 201, at 36 ("While the *Peters* decision was an ambiguous beginning to [determining the scope of the pension clause's protection], the courts in *Kraus*, *Felt*, and *Buddell* each clarified *Peters*' import. These three cases, in turn, held that the Clause safeguards the pension benefit rights contained in the Pension Code when a public employee begins contributing to the pension system whether or not the employee is eligible to retire.").
282. *Id*. at 36–37.
283. *Id*.
284. *Id*. at 37.
285. *Id*.

Conversely, Sidley argues that the Illinois Supreme Court in *Peters* rejected the argument that pension benefits are fixed at the time an employee becomes a member of the system.[286] In Sidley's view, the *Peters* court held that the pension clause only protected benefits which had previously been earned, meaning any benefits accrued from past employment.[287] Moreover, Sidley points out that *Peters* has not been overruled, so its potentially favorable view of prospective modification is still the law.[288] Sidley then argues that *Kraus* is not dispositive because, as an appellate court decision, it is not binding to the extent that it conflicts with the Supreme Court's holding in *Peters*.[289] Lastly, Sidley distinguishes *Felt* and *Buddell*, arguing that the former did not impose a *per se* ban on prospective modifications while the latter is distinguishable on its facts.[290] In Sidley's view, the *Felt* court applied a balancing test like that employed under the Contracts Clause to determine if the modification was reasonable and ultimately concluded that it was not.[291] *Buddell* is likewise distinguishable because the employee's right to purchase military service credit accrued the day he entered the pension system; it was a benefit he had already earned, and the holding is therefore consistent with its interpretation of *Peters*.[292]

Sidley's final argument is that even if future pension benefits were a contractual right, this right could be modified if the employee were given consideration for the change.[293] Under traditional contract principles, consideration for a modification could be a "new benefit to the employee, a new detriment to the employer, or . . . a mutual agreement."[294] The State has the power to reduce salaries and work hours or to terminate employment entirely, so if the State were to forbear from doing such things, it would be a "new detriment."[295] This forbearance from taking other prospective actions would thus be new consideration for the reduced pension benefits.[296] The key to Sidley's position is that the State would give advance notice of the modifications to all affected employees so that they would have a choice to either continue employment with reduced benefit levels or to seek other employment.[297]

Madiar responds by pointing out two flaws in Sidley's argument. First, the State's offer to forbear from modifying other terms and condi-

286. Sidley Memo, *supra* note 215, at 14–15.
287. *Id*. at 16–17.
288. *Id*. at 17.
289. *Id*. at 21.
290. *Id*. at 18–21.
291. *Id*. at 19–20; *see also* Felt v. Bd. of Trs. of the Judges Ret. Sys., 481 N.E.2d 698, 701–02 (Ill. 1985).
292. Sidley Memo, *supra* note 215, at 20–21.
293. *Id*. at 23.
294. *Id*. (citing Doyle v. Holy Cross Hosp., 708 N.E.2d 1140, 1145 (Ill. 1999)).
295. *Id*.
296. *Id*.
297. *See id*. at 24–25.

tions of employment in exchange for a reduction in pension benefits is not credible because most employees are protected by civil service statutes or collective bargaining agreements.[298] Few public employees are employed on an at-will basis, and even those who are would likely be protected from Sidley's proposed maneuver.[299] Madiar argues that the State's forbearance would be so indeterminate as to be illusory, and Illinois courts have implied that modifying other conditions of employment toward the aim of reducing pension benefits would be prohibited by the pension clause.[300]

Even under this alternative theory, the question of whether the pension clause protects future benefits is still germane.[301] If the Pension Clause fixes an employee's contractual rights at the time she becomes a member of the pension system, then the relationship under those terms becomes a *constitutional* right.[302] Discharging an employee for refusing to give up a constitutional right could very well be considered a retaliatory discharge.[303]

Of course, predicting how a future court will decide a particular issue is uncertain business, and it is contingent upon the actual legislation being challenged and the way the record in the case develops. A few things seem likely though. For one, any change to the way judges' pensions are calculated will be excluded.[304] Additionally, both sides of the debate agree that many of the terms and conditions of public employment may be modified, even if they indirectly affect the calculation of pension benefits.[305]

3. Benefits and Limitations of a Political Approach

A political approach has several benefits. First, it would address the issue of pension underfunding without causing the widespread shock to the State's relationships with its creditors that would accompany a bankruptcy filing. Second, as Professor Levitin points out, it would address the underlying issue of the State's fiscal problems.[306] Illinois's pensions are underfunded because of a slumping economy and an historical un-

298. MADIAR, *supra* note 201, at 60–61.
299. *Id*. at 60–62.
300. *Id*. at 61–63.
301. *Id*.
302. *Id*. at 63.
303. *Id*.
304. *See* Sidley Memo, *supra* note 215, at 19. There is a doctrinal reason for this: the constitutional prohibition against diminishing judges' salaries. *See* ILL. CONST. art. VI, § 14 ("Judges shall receive salaries provided by law which shall not be diminished to take effect during their terms of office."). This provision has been construed to protect cost-of-living increases and other forms of judicial compensation. Jorgensen v. Blagojevich, 811 N.E.2d 652, 664–65 (Ill. 2004). Of course, proponents of legislation like Senate Bill 512 must also be aware that any such legislation will be challenged in court, and the presiding judge will be a member of the JRS.
305. *See* MADIAR, *supra* note 201, at 36–37; Sidley Memo, *supra* note 215, at 25.
306. Levitin, *supra* note 157, at 1401–02.

willingness on the part of legislators to meet the State's obligations.[307] Long-term fiscal health will require the State to address the root of its problem through political means. Plus, it should not be discounted that a political solution necessarily takes place through the legislative process, which is the most democratic way to deal with the problem.

At the same time, a political solution has many limitations. Above all, there is no assurance that current legislators will have the political will to make the difficult decisions necessary to fully fund the pension systems. Even if the State resolves to atone for its past irresponsibility, drastic measures including prospective modifications to the benefits of existing employees may run afoul of the Illinois Constitution.[308] At the same time, smaller measures within the bounds of the constitution could be too little, too late. In addition, the cost of compliance with both the constitution and rising pension obligations may force the State to enact severe cuts elsewhere in its budget, which would inhibit its ability to effectively deliver essential government services.[309]

C. Public Pension Funding Authority

A third approach to resolving Illinois's pension problems, and state pension problems in general, would rely on Congress's power to enact uniform laws on the subject of bankruptcies while avoiding some of the problems associated with a full-scale state bankruptcy provision. James Spiotto, a partner at the law firm Chapman and Cutler,[310] has proposed creating a State Public Pension Funding Commission (the Commission) to rescue public pension systems on the brink of default.[311] Subsection 1 presents the legal structure, jurisdiction, and powers of the Commission as presented by Spiotto, Subsection 2 explains its potential benefits, and Subsection 3 explores some of the possible limitations of such an approach.

1. Legal Structure and Powers of the Commission

Constitutional authority for the Commission would come from two of Congress's powers under Article I, Section 8. First, Congress has the authority to "constitute Tribunals inferior to the supreme Court,"[312] which would allow it to establish a tribunal in the first place. Second,

307. *See* Lubotsky & Merriman, *supra* note 189, at 14.

308. *See supra* Part III.B.2.

309. MANCINI & MARTIRE, *supra* note 66, at 4.

310. For background on Mr. Spiotto's practice and publications, see Profile of James E. Spiotto, CHAPMAN AND CUTLER LLP, http://www.chapman.com/attorneys-James-Spiotto.html (last visited Mar. 10, 2013).

311. *See* JAMES E. SPIOTTO, CHAPMAN & CUTLER LLP, UNFUNDED PENSION OBLIGATIONS: IS CHAPTER 9 THE ULTIMATE REMEDY? IS THERE A BETTER RESOLUTION MECHANISM? 30–31 (2011), *available at* http://www.sec.gov/spotlight/municipalsecurities/statements072911/spiotto-slides2.pdf.

312. U.S. CONST. art. I, § 8, cl. 9.

Congress has the power to pass uniform laws on the subject of bankruptcies,[313] which would enable the Commission to have jurisdiction over disputes involving states facing fiscal emergencies.[314] Only a state itself could bring a case before the Commission.[315] A state's voluntary submission to jurisdiction alleviates sovereignty concerns.[316] In Spiotto's formulation, the Commission would consist of five members who would sit for fourteen-year terms, would be independent experts in the relevant subject matter, and would be appointed by the President and confirmed by the Senate.[317]

The Commission's enabling legislation would set forth the basic procedure for a state to bring a case.[318] A state would need to show that "it is incapable of paying its debts as they mature and provide essential governmental services . . . without relief."[319] If so, this would constitute a "governmental emergency," which is the "functional equivalent of insolvency for a government."[320] The enabling legislation would include a set of factors to determine the threshold question of whether a governmental emergency exists.[321] Spiotto suggests modeling the factors on Pennsylvania's test for determining whether a municipality is insolvent.[322] Pennsylvania law provides that a municipality is "financially distressed" if, among other factors, it has run a deficit of one percent or more for three consecutive years, defaulted on a bond, missed a payroll for thirty days, failed to make payments to judgment creditors within thirty days, failed to forward taxes or transfer contributions to Social Security, run a deficit of five percent for two consecutive years, filed bankruptcy, or reached its legal property tax levy and experienced "a decrease in a quantified level of municipal service."[323]

Each of the stakeholders—the state, a representative of retirees, and a representative of current employees who are eligible for pension benefits—would be able to present evidence on whether a governmental emergency exists, and the Commission would determine if the factors were met as a threshold question.[324] Spiotto points out that this step is

313. *Id.* cl. 4.

314. *Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter: Hearing Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary*, 112th Cong. 71 (2011) [hereinafter *Hearing on Public Employee Pensions*] (Statement of James E. Spiotto, Partner, Chapman and Cutler LLP), *available at* http://www.judiciary.house.gov/hearings/printers/112th/112-25_64585.PDF.

315. *Id*.

316. *Id*.

317. *Id*. at 72–73.

318. *Id*. at 71.

319. *Id*.

320. *Id*.

321. *Id*.

322. *Id*.

323. 53 PA. STAT. ANN. § 11701.201 (West 2012).

324. *Hearing on Public Employee Pensions*, *supra* note 314, at 71–72 (statement of James E. Spiotto).

necessary because it permits the Commission to make reasonable modifications under the Contracts Clause.[325] If the Commission determined no such emergency existed, it would dismiss the case in a final, appealable order.[326] If, based on the evidence, the Commission determined that there were a governmental emergency, then the action would proceed.[327] The Commission would then consider evidence from all sides about what "affordable labor cost and pension benefit" package was available "without impairing essential government services."[328] The Commission would have the authority to issue an order to restructure pensions and other post-employment benefits, possibly employing a combination of the reforms discussed in Part III.B. above.[329]

The Commission's order would be appealable to an Article III court by any of the parties involved.[330] After all appeals were exhausted, the state "would be required to implement a plan to meet the terms of the Commission's decision."[331] The Commission would have ongoing jurisdiction over the state to enforce compliance with the terms of the plan.[332] The Commission could do this by withholding certain funds tied to the state's compliance or implement other incentives.[333] For example, the federal government could guarantee the state's bonds or provide the state with access to bridge financing.[334]

Like the state bankruptcy provisions and prospective benefit modifications discussed above, the Commission would have to navigate the constitutional shoals. Spiotto suggests that a state's sovereignty would not be threatened because the Commission would only have jurisdiction over a state that voluntarily brought an action.[335] Moreover, a challenge under the Contracts Clause likely would not succeed. The U.S. Supreme Court's Contracts Clause doctrine allows states to impair a contract if doing so "is reasonable and necessary to serve an important public purpose."[336] Illinois courts will inquire whether there was a "substantial impairment of a contractual relationship," whether the State had a "significant and legitimate public purpose" for the impairment, and whether "the adjustment of the rights and responsibilities of the contracting parties is based upon reasonable conditions and is of a character appropriate to the public purpose of the regulation."[337] The Commission

325. *Id*. at 72.
326. *Id*. at 71–72.
327. *Id*. at 72.
328. *Id*.
329. *Id*.
330. *Id*.
331. *Id*. at 73.
332. *Id*.
333. *Id*.
334. *Id*. at 73–74.
335. *Id*. at 68.
336. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 25 (1977).
337. Royal Liquor Mart, Inc. v. City of Rockford, 479 N.E.2d 485, 491 (Ill. App. Ct. 1985).

would not violate the Contracts Clause because it would only be able to act after determining that there was a governmental emergency.[338] Questions may still persist as to the reasonableness of the remedy, but avoiding a shutdown of essential government services is certainly a significant and legitimate public purpose.[339] The Commission would only have power to act under extreme circumstances, and extreme circumstances would make a Contracts Clause exception more likely.

Spiotto does not explicitly mention Illinois or its pension clause in his proposal. Unlike the Contracts Clause, Illinois courts have resisted arguments in favor of a "reasonable modification" exception to the pension clause.[340] Therefore, in the case of Illinois, the federal legislation creating the Commission would need a provision explicitly authorizing it to modify or reject certain contracts.[341] Absent such a provision, the Commission's ability to modify the pension benefits of existing employees would depend on Illinois courts' construction of the pension clause. Of course, allowing the State's highest court to interpret and apply its own constitution would not be an altogether terrible thing, but a central conceit of this Note is that Illinois law and fiscal policy have already brought the State to the brink of catastrophe.[342] The point here is that Congress *has* the power under the Bankruptcy and Supremacy Clauses to pass legislation that would preempt the State's pension clause.

2. Benefits of the Commission

The Commission would be an effective tool because it would combine Congress's bankruptcy power with the flexibility, creativity, and input of a political approach.[343] Bankruptcy is a powerful tool, but it can be unwieldy. A political solution has the potential to be deftly applied, but it has proven difficult to accomplish. The Commission would provide a forum for each side to present its case to a panel of detached specialists. Members of the Commission would also be constrained by the enabling

338. *Hearing on Public Employee Pensions*, *supra* note 314, at 71–72 (statement of James E. Spiotto).

339. *See Royal Liquor Mart*, 479 N.E.2d at 491.

340. *See* Felt v. Bd. of Trs. of the Judges Ret. Sys., 481 N.E.2d 698, 701–02 (Ill. 1985); *see also supra* Part II.B.

341. Congress might look to the existing Bankruptcy Code for guidance. As noted in Part III.A.1–2 *supra*, § 365 of the Bankruptcy Code gives the bankruptcy trustee the power to reject executory contracts. Congress could do better, however, as many commentators have found § 365 to be "an almost impenetrable legal thicket." TABB, *supra* note 138, at 802–03 (discussing the problems with § 365 that many academics have pointed out).

342. To riff on Professor Skeel's colorful metaphor, the need for a fire department is particularly acute when there is an arsonist on the loose. *See supra* note 148 and accompanying text.

343. *See Hearing on Public Employee Pensions*, *supra* note 314, at 73 (statement of James E. Spiotto) ("Although in an ideal world such a Commission would not be necessary, the Commission strikes a balance between a free-for-all bankruptcy proceeding, the rights of those currently receiving pensions, the rights of States employees, and the rights of the residents of the States to receive essential services.").

statute, especially in their determination of whether there is a governmental emergency.

The Commission would also allow the federal government to step in when a state is in danger of failing to provide "essential government services."[344] To be sure, this protects the residents of the troubled state who depend on services ranging from courts to public aid, but it also protects the federal government and other states. Without legislative action, the federal government would be left with two unsavory options: states defaulting on pension or other financial obligations, or an expensive bailout by taxpayers.[345] Senator Orrin Hatch, the ranking member of the Senate Finance Committee, recently issued a report warning that "[t]he potential effect of state and municipal pension debt on state insolvency or default is significant, and such an event is a possible contagion that could infect even responsible jurisdictions."[346] Senator Hatch goes on to assert that "[i]n the event of insolvencies, the demand for a Federal bailout or bailouts would certainly follow," and this "must be avoided at all costs."[347]

If Illinois continues to put money into pension funds at its current rate, the State may soon reach a point where it cannot meet its other obligations. The federal government can ill afford a state defaulting on its obligations, particularly bonds, because it could adversely affect bond markets well beyond the troubled state.[348] As Senator Hatch's report makes clear, however, a bailout would be unpopular if not impossible.[349] A simple directive to states to "get their houses in order" is insufficient. By offering access to a temporary funding source while being able to issue orders that preempt state law, the Commission would allow the federal government to dangle a carrot and wield a stick to restore the health of state pension systems.

3. Problems with the Commission

The obvious drawback of the Commission is that, like a state bankruptcy law, it does not currently exist and would require federal action to create. The State of Illinois is powerless to institute this change on its own. For its part, Congress is not eager get involved with Illinois's state

344. *Id*. at 71.

345. *See* ORRIN G. HATCH, U.S. SENATE COMM. ON FIN., STATE AND LOCAL GOVERNMENT DEFINED BENEFIT PENSION PLANS 3 (2012), *available at* http://www.hatch.senate.gov/public/_cache/files/ecfaf678-a3ec-45a4-a2bf-3bca4fe9475d/Hatch%20Report%20-%20The%20Pension%20Debt%20Crisis%20that%20Threatens%20America.pdf.

346. *Id*.

347. *Id*.

348. Joshua Rauh, *The Impact of Employee Pension Promises on State and Local Public Finance*, NAT'L BUREAU ECON. RES. REPORTER, No. 1, 2011, at 15, 17, *available at* http://www.nber.org/reporter/2011number1/2011no1.pdf ("[I]ncreases in unfunded pension liabilities are a serious concern for municipal bond investors.").

349. *See* HATCH, *supra* note 345, at 3.

pension issues. In a letter to the party heads in the Illinois General Assembly, Republican leaders in the U.S. House of Representatives stated that "there will be no legislative bailouts from the U.S. House of Representatives," and the federal government would not guarantee the State's pension debt.[350] It is not clear what a "legislative bailout" means in this context, but the Commission would not be a "bailout." It would provide a forum for Illinois to resolve its issues, and the State would be required to repay in full any funding provided to it.

Another possible argument against the Commission is that its power to preempt state law would be inappropriate as a matter of federalism. Many states allow reasonable modifications to their pension systems in times of fiscal distress. But some states, like Illinois and New York, have enshrined the protection of public employees' pension benefits in their constitutions and cast the prohibition on impairing such benefits in "absolute terms."[351] There is some merit to this argument, but the response is that an unmanageable pension liability does not merely affect the troubled state as a governmental entity. The people of the state and taxpayers in all states could suffer as a result.

IV. RECOMMENDATION

The best option for Illinois is a feasible and constitutionally sound political solution in which both the State and its employees are able to agree to changes to the pension system. At the same time, a political approach alone will not be enough; the response must be twofold. First, the Illinois General Assembly should use its existing power to pass certain measures to lower the annual burden for meeting pension costs. Section A outlines these measures and their potential effect. Second, the federal government should create a State Public Pension Funding Commission as a last resort to avoid an interruption to essential government services in the event that a political solution fails. Section B examines how the Commission would be both a strong fulcrum in political negotiations as well as an emergency response.

A. Recommendation for Legislative Reform

The State must enact some measures soon to address its pension funding shortfall. In an ideal world, public employees would consent to certain reductions in prospective benefits. It should be stressed, however, that the funding shortfall cannot be blamed on public employees. They accepted the benefits that the State offered under the terms that

350. Letter from Peter Roskam, Chief Deputy Majority Whip, U.S. House of Representatives, et al. to John Cullerton, Illinois State Senate President, et al. 1 (Oct. 17, 2011) [hereinafter Letter from House Republicans], *available at* http://www.hultgren.house.gov/uploads/IL%20Letter.pdf. Many committee chairs and the entire Illinois House Republican caucus signed the letter. *Id.*

351. *See* MADIAR, *supra* note 201, at 4.

the State would make its agreed-upon contribution.[352] Placing blame for the current shortfall does nothing to ensure the State's future ability to meet its obligations to both its employees and private residents. Therefore, the solution may require a dispassionate willingness to apply leverage where necessary and to begin with legislation that is on safer constitutional footing. With that in mind, the State should take the following steps: (1) adjust the mandatory retirement age, (2) tie costs-of-living adjustments to the standard rate of inflation, and (3) when renegotiating CBAs, require employees under a defined-benefit plan to elect either a salary reduction or a switch to a defined-contribution plan along with salary incentives.

Illinois should raise the age at which employees can retire. The current rules for employees hired before January 1, 2011, are somewhat complicated. For example, SERS employees can retire with full benefits at age sixty, provided they have eight years of credited service, or at any age if they satisfy the "rule of eighty-five."[353] Members of TRS can retire with full benefits at age fifty-five if they have twenty years of credited service, or they can retire at age sixty-two if they have five years of credited service.[354] The State recently raised the retirement age for employees hired on or after January 1, 2011.[355] After completing at least ten years of service, new hires can retire with full benefits at age sixty-seven or with reduced benefits between ages sixty-two and sixty-seven.[356] The State should make a full pension conditional on working until age sixty-seven for all employees, excluding judges and other employees who have additional constitutional protections of their compensation and tenure.

Illinois should also reduce annual cost-of-living adjustments until the system reaches full funding. Currently, Illinois retirees receive an annuity with a three percent cost-of-living adjustment (COLA) compounded annually.[357] Employees hired after January 1, 2011, will be entitled to an annuity with a COLA that is the lesser of three percent or one-half the annual increase in the consumer price index-u (CPI-U).[358] The CPI-U is the U.S. Bureau of Labor Statistics' measure of "All Items Consumer Price Index for All Urban Consumers," and it is a widely used indicator of inflation.[359] By basing COLAs on a standard measure of in-

352. *See* MANCINI & MARTIRE, *supra* note 66, at 3.

353. 40 ILL. COMP. STAT. 5/14–107 (2010) (providing that an employee may retire at any age as long as the sum of the employee's age and years of creditable service equals at least eighty-five).

354. *Id.* § 5/16-132.

355. *See id.* § 5/1-160(c)–(d) (codifying Public Act 96-0889, 2010 Ill. Laws 24–25).

356. *Id*.

357. GREGG SCOTT & MALLORY MORTON, COMM'N ON GOV'T FORECASTING & ACCOUNTABILITY, A REPORT ON THE FINANCIAL CONDITION OF THE IL STATE RETIREMENT SYSTEMS: FINANCIAL CONDITION AS OF JUNE 30, 2010, at 31, 43, 55, 67, 79 (Mar. 2011), *available at* http://www.ilga.gov/commission/cgfa2006/Upload/FinCondILStateRetirementSysMarch2011.pdf.

358. 40 ILL. COMP. STAT. 5/1-160(e).

359. *Frequently Asked Questions*, BUREAU OF LAB. STAT., http://www.bls.gov/cpi/cpifaq.htm#Question_13 (last modified Oct. 19, 2011).

flation, retirees and the State share risk; workers are at least partially insulated from rapid inflation while the State is protected from over-paying for cost-of-living adjustments in times of low inflation or stagnation.[360] Therefore, the COLA should be reduced for all employees until the systems are healthy.

The State should also consider Rhode Island's approach and suspend annual COLAs until the pension system reaches a particular funding target.[361] Under Rhode Island's recent pension reform law, the COLA will be suspended until all plans are at least eighty percent funded.[362] In the interim, retirees will receive a standard COLA once every five years, and each adjustment will be calculated by taking the average of actual investment returns over the previous five years, minus 5.5 percent.[363] The Rhode Island approach pushes more of the risk onto employees than Illinois's recent reforms for new hires, and it ties pension benefits to the overall health of the pension system.[364]

The State's next step should be to enact provisions similar to those included in House Bill 3411.[365] The State should establish a tiered system under which employees hired before January 1, 2011, must accept reduced benefits.[366] Proponents of House Bill 3411 estimate that it will save $160 billion.[367] If the changes were passed and upheld, Illinois would be healthier in the long run.

Many, if not all, of these changes would be challenged in court as violations of the pension clause. The Illinois Supreme Court has not ruled definitively on the issue of whether prospective modifications to the benefits of current employees are permitted.[368] The legal costs to the State of defending such a challenge would be sizeable, but the State stands to save many multiples of that amount if the courts uphold the reforms. Illinois should take these steps soon to begin reducing its unfunded pension liability. If Illinois's efforts fail, however, the federal government should step in to provide legal relief in the form of a debt-

360. Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSP., Fall 2009, at 191, 196.

361. *RIRSA Executive Summary*, *supra* note 194, at 1.

362. *See* Actuarial Analysis of RIRSA, *supra* note 199, at 2 (providing an actuarial analysis of the pension reform law).

363. *Id*. at 4. In any event, the COLA will not be more than four percent or less than zero percent. *Id.* The investment return assumption for Rhode Island's retirement plans is 7.5%, so under normal conditions the COLA would be around 2%. *Id*.

364. The argument against tying employees' benefits to the overall health of the system is that employees do not control the State's purse strings and therefore cannot require the State to maintain a particular funding level.

365. *See supra* notes 203–12 and accompanying text.

366. *See generally* H.B. 3411, 98th Gen. Assemb. (Ill. 2013).

367. Press Release, Ill. House Republicans, Cross, Nekritz Pension Bill Passes Committee (Mar. 14, 2013), *available at* http://news.ilhousegop.org/2013/03/press-release-cross-nekritz-pension-bill-passes-committee/.

368. *See supra* Part III.B.2.

restructuring forum before it is called on to provide financial relief in the form of a bailout.

B. Implementing a Federal Commission

At the federal level, Congress should pass legislation enabling a public pension funding commission. If Illinois or any other state cannot enact meaningful reform to fund pensions and maintain government services, the federal government would likely become involved in the fallout in some form.[369] Despite the clear statements of some congressional Republicans,[370] the federal government must have some mechanism in place for emergencies while preventing the moral hazard attendant to bailouts.

The Commission would be a fact finder, an enforcer, and a funding source. As a threshold question, it would hear evidence and determine whether a governmental emergency exists. If such an emergency did exist, the Commission would hear further evidence and recommend a plan to restructure the state's pension obligations. In many cases, the plan would contain similar elements to those listed in the previous section.[371] In the case of Illinois, the Commission would be able to recommend modifications to the retirement age, the COLA, employees' individual contributions to their pensions as a percentage of salary, and the defined-benefit structure.[372]

There are three main benefits to having the Commission make these recommendations. First, the Commission would be enabled by Congress's power to enact uniform laws on the subject of bankruptcies. As a result, it would have the power to alter the obligations of contracts in ways that would not be allowed under state law. This means that the pension clause in the Illinois Constitution would not be an absolute bar to modification of pension benefits. Second, the Commission would maintain ongoing jurisdiction to enforce its order. While it could not raise taxes unilaterally or assume other sovereign powers of a state, it could link the state's compliance to the disbursement of "future federally designated funds."[373] This bleeds into the third point: the Commission could provide bridge financing or it could guarantee pension restructuring bonds.[374] Some in Congress might balk at providing financing because it is akin to a bailout.[375] Whatever the appellation, financial assistance is the best option because it facilitates a permanent solution to states' pension funding problems, and it would be cheaper than the alternative, namely, a state default and the risk of contagion. As with any dif-

369. HATCH, *supra* note 345, at 3.
370. Letter from House Republicans, *supra* note 350.
371. *See supra* Part IV.A.
372. *See supra* Part IV.A.
373. *Hearing on Public Employee Pensions*, *supra* note 314, at 73 (statement of James E. Spiotto).
374. *Id*. at 73–74.
375. *See, e.g*., Letter from House Republicans, *supra* note 350.

ficult public policy issue, the perfect should not be the enemy of the good.

V. CONCLUSION

Illinois is in the throes of a fiscal crisis. The crisis has many causes, but chief among them is a growing unfunded pension liability that is burdening the State's budget and threatening its ability to provide essential government services to its residents. The headwinds to pension reform efforts include a political inability to reach a workable compromise and legal limitations on the State's ability to do what is necessary to restore its pension systems to financial health.

One proposal for pension reform is to amend the federal Bankruptcy Code to enable states to file for bankruptcy. The amendment would be modeled on chapter 9 of the existing Bankruptcy Code, and it would allow states to voluntarily submit to jurisdiction in a federal bankruptcy court. Under § 365 of the Bankruptcy Code, a debtor-state would be able to reject its pension obligations that have not yet accrued. This proposal should be rejected because it would be overly broad and unsettle far too many of the state's debtor-creditor relationships.

A second proposal is to work through the state's political processes to achieve a solution. For Illinois, this should include changes to the mandatory retirement age, COLAs, and the defined-benefit structure under the Illinois Pension Code. Illinois has a clause in its constitution that makes public pension an enforceable contractual obligation which cannot be diminished or impaired. The scope of this clause, and thus the fate of many proposed pension reforms, is still unclear. Given the severity of the problem, however, the State should pass reforms that would reduce the total unfunded liability while lowering annual contributions.

Finally, as a last resort, James Spiotto has proposed creating an independent federal commission to review troubled pension systems, make recommendations to the reforms mentioned above, and implement those reforms by enforcing its order and providing bridge financing to the State. This would reduce the risk of default, contagion, and a bailout of state pension systems. Moreover, it would preempt state law barriers to reform by using Congress's power to pass uniform laws on the subject of bankruptcies. The Commission would serve as both a flexible debt restructuring mechanism and a backstop to negotiations between states and their employees.

A solution to which all parties can agree is desirable but unlikely. The reforms outlined in this Note provide Illinois with a means to address its pension funding problems with due consideration to the gravity of the problem and the consequences of inaction. Any solution will be painful. Doing nothing will be worse.