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Jane Chapman†

INTRODUCTION

*The Wire*, a popular television drama on HBO from 2002 to 2008, offers a powerful picture of the unfulfilled American promise through its focus on declining urban institutions at the turn of the twenty-first century. Season Two portrays the plight of modern-day union employees and their struggle to maintain stability in an environment that no longer promises the same benefits enjoyed by their forefathers—such as that of the pension, which was once seen as the pathway to the middle class, but now lies on the political chopping block.

Unfunded pension liability at the state level has been the focal point of conversations among legal scholars, government officials, and program participants. At present, the sustainability of such programs is in doubt, as government data shows that current public pension plans cover twenty-seven million Americans, with more than $1 trillion in unfunded pension benefits owed to such workers. While the problem is nationwide, a few locales in particular feel the immediacy of impending insolvency most acutely. In Chicago, for example, Mayor

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1 U.S. GOVT ACCOUNTABILITY OFF., GAO-12-322 STATE AND LOCAL GOVERNMENT PENSION PLANS: ECONOMIC DOWNTURN SPURS EFFORTS TO ADDRESS COSTS AND SUSTAINABILITY 1 (2012), http://www.gao.gov/assets/590/589043.pdf [https://perma.cc/NSU3-SX5F]. Note that this data is already five years old, which is relatively dated given the pace at which pension plans’ funds are depleting.


3 See, e.g., *id.* at 367 (“Pension debt is so significant in some cities and states that credit
Rahm Emanuel “warned that . . . pension debt will require the city to lay off thousands of police officers and firefighters, end rat-control programs and let street repairs lapse, among other cuts.” As of August 2016, Illinois’s pension plans were only 34 percent funded.\footnote{Id. (quoting Mary Williams Walsh, \textit{Rhode Island Averts Pension Disaster Without Raising Taxes}, \textit{N.Y. Times} (Sept. 25, 2015) (internal quotations omitted), https://www.nytimes.com/2015/09/26/business/dealbook/rhode-island-averts-pension-disaster-without-raising-taxes.html (last visited May 7, 2018).}

At the core of this is a zero-sum dilemma—cities and states plagued by public pension crises face issues of scarcity. Throughout Illinois’s history, for example, the State has struggled to fund the public pension system in addition to maintaining other government programs and services.\footnote{Liz Farmer, \textit{Pension Crisis: Could Buyouts Be a Solution?}, \textit{Governing Magazine} (Sept. 15, 2016), http://www.governing.com/topics/finance/gov-pension-crisis-buyouts.html [https://perma.cc/SY8D-LPQ2].}

This Comment focuses primarily on the State of Illinois’s looming pension crisis—how the crisis came to be, the legislature’s unsuccessful attempts to remediate it, and the judiciary’s hardline stance upholding plan participants’ constitutional rights against any reductions to their benefits. After considering the legal restraints on reforming Illinois’s pension, the Comment turns to consider possible solutions that pass constitutional muster. Specifically, this Comment proposes a third-party annuitization option in which the State buys annuities from large insurance companies through an open-market bid system and offers current pension participants the option to receive their benefits through those private annuities.

Part I gives a brief overview of how public pensions work. Part II explores the history of pension problems in Illinois and how various reform efforts have resulted in the State having one of the most protective legal regimes for pension participants in the country. Part III puts the situation in Illinois in context by providing an overview of the three main legal theories states have used to understand pensioners’ legal rights. After walking through the different legal theories, Part IV turns to look at how those theories might fit into a framework similar to that created by Employee Retirement and Income Savings Act (ERISA) in 1974, which helped private pension plans avert insolvency. Here, the Comment examines whether ERISA could serve as a model for reforms in the public context. Part V compares an ERISA-based reform with other reforms scholars have proposed, concluding that while
many of these reforms would ameliorate pensions’ funding gaps, they are either unsustainable or unconstitutional under Illinois’s Pension Protection Clause. Finally, Part VI discusses what a buyout might look like and the structural considerations needed for viable third-party annuitization.

I. AN OVERVIEW OF PUBLIC PENSION PLANS

Public pensions are retirement plans for state and local workers such as law enforcement officers, firefighters, and teachers in which participants earn monthly pensions for a lifetime of work. They are typically defined benefit plans—those in which “the amount of benefits paid to the employee after retirement is fixed in advance in accordance with a formula given in the plan.”7 Unlike private plans, public sector plans are not subject to federal supervision.8 The National Association of State Retirement Administrators (NASRA) lists the following as generally universal features of public pension plans: mandatory participation, cost sharing between employers and employees, pooled and professionally managed assets, targeted income replacement, lifetime benefit payouts, survivor and disability benefits, and supplemental savings.9 Funding models for traditional pension plans rely on assumptions about how long participants will live (longevity risks) and how well the market will perform (market risks).10

Despite the seemingly formulaic process by which states fund and administer pension funds, a number of states’ pension liabilities have ballooned in recent decades. While some of these deficit increases have stemmed from tortious conduct such as fund mismanagement and political self-dealing, a great deal of the deficits have stemmed from the fact that more participants are living longer and states have failed to set aside sufficient pension payments. Rather than respond by returning to principles of financial prudence, however, trustees have instead turned to more volatile investments in hopes of beating the market

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7 MERRIAM-WEBSTER’S DICTIONARY OF LAW 129 (1st ed. 1996). In contrast, few private pensions are defined benefit (those that are use the term “annuity” instead of “pension”). Instead many private pension plans have switched to defined contribution plans in which “a worker builds up a retirement savings account, invests the principal, and then draws down the account in retirement.” See Paul M. Secunda & Brendan S. Maher, Pension De-Risking, 93 WASH. U. L. REV. 733, 735 (2016).

8 Terrance O’Reilly, A Public Pensions Bailout: Economics and Law, 48 U. MICH. J. L. REFORM 183, 194 (2014). The separation between federal oversight in private pensions, but not public pensions is also a source of legal difficulty that this Comment discusses in the proposed reform section.


10 Monahan, When a Promise is Not a Promise, supra note 2, at 359.
and closing funding gaps. These riskier investments have come with higher fees and consequently “push[ed] pension funds deeper into the hole.” Although trustees have asserted that these high-risk investments will be good for the State in the long-run, the likelihood of this outcome is becoming less and less likely under actuarially sound principles.

II. ILLINOIS’S TROUBLED HISTORY WITH PENSIONS

“In the resulting give and take, public pensions have chronically suffered.”

A. The State’s Initial Attempts to Systematize Pensions

Public pension policies in Illinois date back to the mid-1800s. By 1917, when the State established the Illinois Pension Laws Commission (“Commission”), Illinois had fifteen pension laws on the books, under which thirty-five separate pension funds existed. A report commissioned by the General Assembly that year characterized the pension system as “financially unsound and moving toward a crisis.” The Commission was tasked with investigating pension operations and ensuring compliance with relevant laws, an attempt to put the State’s pensions back on course.

11 PEW CHARITABLE TRUSTS, STATE PUBLIC PENSION FUNDS INCREASE USE OF COMPLEX INVESTMENTS 13 n.9 (Apr. 2017), http://www.pewtrusts.org/~media/assets/2017/04/psrs_state_public_pension_funds_increase_use_of_complex_investments.pdf [https://perma.cc/MM6G-PE4E] (“Public pension plan data for 2014 collected from the largest state-sponsored pension funds reveal that most state retirement systems allocated between 70 and 80 percent of their portfolios to equities and alternative investments that historically have been more volatile than fixed-income investment assets. And “the shift to alternative investments has coincided with a substantial increase in fees as well as uncertainty about future realized returns, both of which could have significant implications for public pension funds’ costs and long-term sustainability.”).


13 Id. (statement by Bill Bergman, director of research at Truth in Accounting, and former economist and financial market policy analyst at the Federal Reserve Bank in Chicago) (“In Illinois, the defense is that in the long run, these investments will be good for us. But they are expensive, opaque and risky.”).

14 In re Pension Reform Litigation, 32 N.E.3d 1, 6 (Ill. 2015).

15 REPORT OF THE ILL. PENSION LAWS COMM’N OF 1917 272 (1917) (“The policy of providing pensions for public employees in Illinois began in a limited way in 1852, was materially extended in the 70’s [sic].”), https://archive.org/stream/reportillinoisp01hookgoog/page/n280/mode/2up [https://perma.cc/PA24-27K9].

16 Id.

17 Id. (noting too, that “the various public pension schemes [] existing under the laws of Illinois for public employees [were] inharmonious and often contradictory with reference to each other . . .”).

18 I
In 1949, the State established a division of the Department of Insurance (the “Division”) to regulate public pensions. Subsequent reports from the Commission, however, reveal that little regulation occurred. In 1959, the Commission reported that unfunded liabilities continued to increase because of the government’s inadequate contributions in prior years. In 1969, the Commission noted that appropriations for State-financed pension funds, which fell short of the mandatory statutory minimum, were “grossly insufficient.” This shortfall would become a focal point of the constitutional convention the following year.

B. The 1970 Constitution and Pension Protection Clause

During the summer of 1970, the legislature convened for a Constitutional Convention, where delegates debated how best to protect public pension funds. During the convention, one delegate observed that:

[P]articipants in these pension systems have been leery for years of the fact that the—this matter of the amount the state has appropriated [for pensions] has been made a political football, in a sense. In other words, in order to balance budgets, you see, the party in power would just use the amount of the state contribution to help balance budgets, and this had gotten to the point where many of the so called pensioners under this system were very concerned; and I think this is the reason that pressure is constantly being placed on the legislature to at least put a fair amount of state resources into guaranteeing payment of pensions.

The delegate’s sentiments were met with general agreement and the legislature voted 57-36 in favor of adding the Pension Protection Clause to the broader constitutional draft. The clause made it clear that the State could not take any actions that might diminish or im-

21 In re Pension Reform Litigation, 32 N.E.3d 1, 6 (Ill. 2015) (quoting REPORT OF THE ILLINOIS PENSION LAWS COMMISSION OF 1969 106 (1969)).
23 Id. at 2893–2963. The clause provides that “[m]embership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.” ILL. CONST. art. XIII, § 5.
pair pensioners’ benefits. Its promise to hold pension participants’ benefits as constitutionally protected rights seemed to remove any uncertainty about pensions’ future funding.

C. Continued Funding Problems (1970–2013)

Despite the ironclad protections the 1970 Constitution provided, the State nevertheless failed to adhere to statutorily-required funding levels and diverted funds earmarked for public pensions to instead cover other government costs. In 1993, the then-comptroller, Dawn Clark Netsch, testified before the United States Congress that states were failing to adequately fund their pensions and instead deferring their obligation to future generations. As a result, in 1995, the legislature implemented an aggressive plan to tackle the funding gap that relied on a phased-in “ramp period” and projected that State retirement plans would be 90% funded by 2045. The ramp period never occurred, however, because the legislature subsequently lowered its contributions in 2006 and 2007.

By 2013, the State’s pension woes had garnered the attention of the Securities and Exchange Commission (SEC), which charged Illinois with securities fraud and ordered the State to cease-and-desist from misleading municipal bond investors about the State’s approach to pension funding. The SEC found that by continuing to push back pension payments to future dates, Illinois had structurally underfunded its pension system, thereby creating significant financial stress and risk. Furthermore, the SEC found that the State’s unfunded liability between 1996 and 2010 increased by $57 billion.

The growing deficits and increasing national coverage of its pension gap might explain the General Assembly’s urgency in drafting Public Act 98-599, which made no effort to hide its objective of reducing participants’ benefits. In fact, during the General Assembly’s discussion of the bill, one of the Senate sponsors of the bill acknowledged

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24 In re Pension Reform Litigation, 32 N.E.3d at 8.
25 Id. at 8–9 (quoting Dawn Clark Netsch, State Pension Raids Rampant in the 1990s, ILL. MUN. REV. 15, 15 (Feb. 1993) (explaining that “[u]nderappropriated pension contributions are like unpaid credit card bills. The liability does not go away just because you choose not to pay the bill when it is due. You still owe the unpaid balance, plus interest.”)).
26 P.A. 88-593, eff. Aug. 22, 1994; see 40 ILCS §§ 5/2-124 to 2-126, 14-131 to 14-133.1, 15-155 to 15-1557.1, 16-154, 16-158, 18-131 to 18-133.1.
27 In re Pension Reform Litigation, 32 N.E.3d at 9.
30 Id.
that “the legislation intend[ed] to and [would] have a direct and substantial impact on the benefits of current employees and retirees by reducing their benefits.”

The fact that sponsors of the bill acknowledged its intended goals under terms that are expressly prohibited by the pension protection clause seems to indicate the direness of the situation—at least in the eyes of the Illinois legislature. By this point in time, the State not only faced pressure on the public pension front, but even more so to pass a state budget.

D. In re Pension Reform Litigation

In 2015, the Supreme Court of Illinois addressed the constitutionality of Public Act 98-599 head on in In re Pension Reform Litigation (“Pension Reform Litigation”), where it held that public employees’ pension rights could not be reduced or impaired under any circumstances, regardless of any financial distress of the relevant public entity. In that case, members of the State’s public retirement systems and representative groups brought suits challenging Public Act 98-599. In a unanimous opinion striking down the law as unconstitutional.

31 The following back-and-forth is an example of senators’ candor with regard to the proposed legislation’s effect on pension participants:

SENATOR HUTCHINSON: Am I correct that the legislation intends to and will have a direct and substantial impact on the benefits of current employees and retirees by reducing their benefits?

SENATOR RAOUL: Yes. You are correct.

SENATOR HUTCHINSON: I know that one of the objectives of this legislation is really to improve the State’s credit rating. Is that correct? I mean, that’s why we’re here.

SENATOR RAOUL: It—it’s one of—one of—one of the State’s fiscal issues, yes, and one—one of the objectives.

SENATOR HUTCHINSON: So, then, is it fair to say that we are sacrificing a substantial amount of people’s pension benefits to protect the State’s finances?

SENATOR RAOUL: Yeah, I—you know, that’s a harsh characterization, but—but I—I suppose yes.”


33 See, e.g., In re Pension Reform Litigation, 32 N.E.3d. 1, 18–20 (Ill. 2015); Burgos v. State, 118 A.3d 270 (N.J. 2015).

34 In re Pension Reform Litigation, 32 N.E. 3d at 4.
tional, the Illinois Supreme Court explained that “the United States Supreme Court has held that particular scrutiny of legislative action is warranted when, as here, a state seeks to impair a contract to which it is itself a party and its interest in avoiding the contract or changing its terms is financial.”35

E. Current State of Affairs

Despite the legislature’s expressed commitment to fixing decades of underfunding, the 1970 Constitutional changes have had mixed results. On the one hand, it has enhanced pension beneficiaries’ legal standing and right to redress when their benefits are infringed. On the other hand, pension deficiencies have not only persisted, but have gotten worse.36

Today, there are three main sources for funding the Illinois benefit system: (1) the income, interest, and dividends derived from retirement fund deposits and investments; (2) contributions by the State through appropriations by the General Assembly; and (3) contributions by or on behalf of participants based on their salaries.

The problems that have afflicted the State for a century persist,37 as does the legislature’s interest in attempting to remedy the mess.38 In Spring 2017, Barbara Flynn Currie, a Democratic member of the Illinois General Assembly, introduced a bill that would require pension participants to choose between two options—they could either continue counting future pay increases toward their pensions, but give up automatic inflation adjustments, or agree to exclude any future pay increases from counting towards their pension, while still receiving the automatic inflation adjustment rate.39 Currie’s bill also proposes closing the General Assembly Retirement System to new members and offering pensioners a buyout plan in which they may cash in their benefits for a lump sum payment.40

35 Id. at 21 (citing United States Trust Co. of New York v. New Jersey, 431 U.S. 1, 24 (1977) (“[T]he Court has regularly held that the States are bound by their debt contracts.”)).
36 Id. at 9.
38 See id. (quoting Sen. Dale Righter) (“It’s no secret Illinois’ pension costs are draining tax dollars from high-priority areas. But I don’t think people realize just how bad it is.”).
39 Id.
40 Id.
F. The Illinois General Assembly is Constrained in Its Ability to Reform

Although the Illinois judiciary has consistently upheld participants’ benefits as legally protected, it has been unable to articulate a viable method of legal recourse for those participants to procure such benefits.\textsuperscript{41} This is, in part, because pension appropriations are controlled by the legislature. Since the legislature cannot decrease pensioners’ annuities, politicians have often pointed to mechanical solutions such as increasing taxes to more quickly make up the deficit. Unfortunately, increasing taxes is rarely a politically palatable action for the legislature to take.\textsuperscript{42} And with the next election never too far away, legislators almost always have the incentive to focus on satisfying constituents’ short-term needs at the expense of fulfilling its long-term duty to adequately fund the pensions. The result is that pensions are systematically shortchanged.\textsuperscript{43}

All of this suggests that the problem requires a much deeper solution than merely adjusting tax levels. Instead, reformers must look for ways to separate legislators’ inherently political calculations from those related to funding state pension plans.

III. FRAMEWORKS FOR UNDERSTANDING PENSIONERS’ LEGAL RIGHTS

Although Illinois stands out as one of the most drastic examples of pension debt, it is one of many states where questions about pensioners’ legal rights are being litigated in court. At present, the most hotly debated questions relate to what changes to public pension plans are permissible.\textsuperscript{44} Historically, legislatures categorized pensions as “gratuiites” that the state could change at will. For example, before

\textsuperscript{41} See Monahan, When a Promise is Not a Promise, supra note 2, at 391 (“The bottom line for pension participants in a state plan with a depleted trust fund is that, regardless of their rights to benefit payment, it may be difficult or impossible to use law to enforce such rights.”).

\textsuperscript{42} It comes as no surprise that a growing body of scholarship suggests there is currently no check on legislatures’ spending or other actions in the context of pension funding. Compare Amy B. Monahan, State Fiscal Constitutions and the Law and Politics of Public Pensions, 2015 U. ILL. L. REV. 117, 129 (2015) (attributing the lack of counterbalance to: (1) participants’ overly-optimistic reliance on courts’ assurances of their right to benefits, (2) lack of organized lobbying efforts on participants’ behalf, and (3) short election cycles that make spending on long-term costs less salient to both voters and candidates), with Burgos v. State, 118 A.3d 270, 298 (N.J. 2015) (noting that legislators can be held accountable for their spending decisions in a way that the judiciary traditionally cannot).

\textsuperscript{43} The funding deficit has grown to the point that states would need to tax individuals, on average, an extra $1,385 per year to fully fund their pensions systems within the next 30 years. Some states, likely including Illinois, have an annual shortfall of over $2,000 per year. Robert Novy-Marx & Joshua Rauh, The Revenue Demands of Public Employee Pensions Promises, 6 AM. ECON. J.: ECON. POL. 193 (Feb. 2014).

\textsuperscript{44} Brainard & Brown, supra note 9, at 5.
1970, the law afforded governments the flexibility to adjust pension contributions or eliminate them altogether. Over time, however, pensions have gained an elevated legal status under theories of contract rights and property rights, as well as state constitutional protections.

A. Pension Benefits as Property Rights

A number of states interpret pensions as conferring property rights to their respective beneficiaries. While some states, such as New Mexico, afford pension benefits strong property protections, others, such as Maine, afford weak protections. The property approach involves an analysis of employees’ rights in light of the Fifth and Fourteenth Amendments to the U.S. Constitution, which bar depriving individuals of their property—in this case, pension benefits—without “due process of law” and “just compensation.”

Plaintiffs have had great difficulty bringing substantive due process claims against the government. In order to succeed on such a claim, a plaintiff needs to show that she has a fundamental right to her pension benefits, that the state deprived her of that right, and that it did so “arbitrarily” or “capriciously.” Courts have afforded legislatures a high degree of deference when states have shown they were faced with a fiscal shortfall that demanded changes to pension provisions. Accordingly, courts have time and again given state legislatures the go-ahead to make changes like increasing the retirement age...

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45 Furchtgott-Roth, supra note 20, at 4.
46 According to employment law scholar Professor Amy B. Monahan, the ability of state legislatures to alter the pension benefit programs of current employees is a function of whether that state’s judicial system views pension benefits through a property or contract-based approach. Amy B. Monahan, Understanding the Legal Limits on Public Pension Reform, AM. ENTER. INST. 1–2 (May 2013), http://www.aei.org/files/2013/05/29/-understanding-the-legal-limits-on-public-pension-reform_104816268458.pdf [https://perma.cc/UH84-CP2G].
47 See, e.g., ARIZ. CONST. art. XXIX, § 1 (“Membership in a public retirement system is a contractual relationship that is subject to article II, § 25, and public retirement system benefits shall not be diminished or impaired.”); ILL. CONST. art. XIII, § 5 (“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.”); ALASKA CONST. art. XII, § 7 (“Membership in employee retirement systems of the State or its political subdivisions shall constitute a contractual relationship. Accrued benefits of these systems shall not be diminished or impaired.”).
49 U.S. CONST. amend. V.
50 Monahan, Understanding the Legal Limits, supra note 46, at 2.
51 Id.
for pension eligibility,\textsuperscript{52} altering the definition of compensation,\textsuperscript{53} and increasing the penalty for an employee’s withdrawal from employment before reaching retirement age.\textsuperscript{54}

Similarly, plaintiffs’ takings claims have been almost uniformly unsuccessful. Courts have held that legislative changes to pension plans are merely regulatory changes, not takings within the meaning of the Fifth Amendment, because pension participants benefits do not constitute “investment-backed expectations.”\textsuperscript{55}

### B. Pension Benefits as Contract Rights

A number of state courts have limited changes to pension plans based on the Contracts Clause of the U.S. Constitution, which provides that “No State shall . . . pass any . . . law impairing the obligation of contracts . . . .”\textsuperscript{56} In order to show that a state violated the Contracts Clause, one must show that a contractual relationship was substantially impaired, that the state lacked a “significant and legitimate public purpose behind the regulation,” or that “the adjustment of the rights and responsibilities of contracting parties” was not based on “reasonable conditions” or “of a character appropriate to the public purpose.”\textsuperscript{57}

Even among states that consider pensions to be binding contracts, there remains the question of what that contract includes.\textsuperscript{58} In Florida, for example, as long as reforms do not change the amount of benefits employees already accrued, the legislature can change benefits going forward.\textsuperscript{59} Oklahoma provides even less protection, allowing the legislature to change employees’ benefits at any point before they retire.\textsuperscript{60} In other words, where some states might consider the contract as an agreement to retain pension formulas at least as generous as those that were in effect when the employee was hired (term vesting), others might understand the contract right as merely an agreement to

\textsuperscript{52} Farmer, \textit{supra} note 5.

\textsuperscript{53} Id.

\textsuperscript{54} Monahan, \textit{Understanding the Legal Limits, supra} note 46, at 3.

\textsuperscript{55} Courts have consistently found amendments to public pension plans as representing “an adjustment to the benefits and burdens of economic life” rather than a taking of private property without just compensation. However, plaintiffs may be more successful in takings claims if the program were to change after the individual was accepting benefits. See Parker v. Wakelin, 937 F. Supp. 46, 58 (D. Me. 1996); Pineman v. Fallon, 842 F.2d 598 (2d Cir. 1988).

\textsuperscript{56} U.S. CONST. art. I, § 10.


\textsuperscript{58} See Volokh, \textit{supra} note 48.

\textsuperscript{59} See Brainard & Brown, \textit{supra} note 9, at App’x 21.

\textsuperscript{60} See id. (listing reforms the Oklahoma implemented that affected both current and future employees, such as increasing the age for normal retirement, implementing a minimum retirement age, and freezing cost-of-living (COLAs) increases in benefits).
pay the pension benefits that have been earned based on work already completed.61

Under the alternative “contract” approach, pension participants are provided greater protections based on the “promise” of pension payouts in state and federal constitutions.62 If a court finds a contractual relationship binding, such that a state must deliver the employee’s pension benefits in exchange for the public services she has rendered, then any action by that state that substantially impairs the employee’s benefits is unconstitutional.63 Under this theory, the Supreme Court of Illinois held in 2015 that public employees’ pension rights could not be reduced or impaired under any circumstances, regardless of any financial distress of the relevant entity.64

Notwithstanding the greater procedural protections provided by the contract approach, courts remain split in their determination of the specific time in which a contract is created as to become binding.65 On the one hand, some states believe the contract is formed on the first day of an employee’s employment for the state, and that employees are protected against any subsequent detrimental changes to their pension plans.66 In contrast, other states view a contract as existing only once the employee has retired and started to receive benefits under the plan. Such a view offers less protection to current public pension plan holders where the legislature makes changes. Bridging these two approaches, a very small subset of states treats a contract as existing once an employee satisfies the minimum service requirements to receive a pension.67

C. Pension Benefits as Constitutional Rights

While almost all states provide at least some degree of legal protections to pension beneficiaries in the form of property or contract rights,68 some go beyond that.69 Alaska, Arizona, and Illinois have in-

61 See Volokh, supra note 48.
62 Monahan, Understanding the Legal Limits, supra note 46, at 3.
63 Id.
64 See, e.g., In re Pension Reform Litigation, 32 N.E.3d. at 18–20 (Ill. 2015); Burgos v. State, 118 A.3d at 270.
65 Monahan, supra note 46, at 4.
66 Id. at 2.
67 Id. at 4. In order to determine if the parties intend to form a contract, courts will first look at the language related to pension provisions in the state constitution. The easiest case of contract formation occurs when the legislature explicitly states that public pension benefits are to be considered contractual in nature. Harder determinations must be made when the court must infer based on legislative history if the legislature intended a contract.
68 See Farmer, supra note 5.
69 Id.
cluded constitutional provisions that prohibit their respective legislatures from altering participants’ benefits or rights.\textsuperscript{70} The rationale underlying these limitations is that legislatures have few incentives to make decisions that yield long-term gains in the place of short term gains.\textsuperscript{71} In keeping with this notion, most state courts have interpreted these constitutional provisions as protecting future generations of participants from having their benefits “stolen” at least not without a vote of the public.\textsuperscript{72}

The core purpose of debt limitations is to restrict the current legislature from financially binding future generations, yet unfunded pension liabilities are doing just that.\textsuperscript{73} In Illinois, as well as a handful of other states, pension participants’ benefits are constitutionally protected, which makes it almost impossible for the legislature to make any changes that would decrease their pension liability.\textsuperscript{74} Such specific protections reflect those states’ deep commitment to fulfill pensioners’ rights, but they also pose significant challenges for state legislatures struggling to reach budget agreements and maintain current public services.

Even in the context of constitutional provisions, which generally confer the highest level of protection, their effectiveness depends on how state legislatures and courts define “debt.”\textsuperscript{75} For example, although Arizona and Illinois’s constitutions both include a pension protection clause, Arizona recently passed reforms that would apply to new hires only by amending the pension clause to exempt that particular statute.\textsuperscript{76}

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\item[70] O’Reilly, supra note 8.
\item[71] Monahan, \textit{When a Promise is Not a Promise}, supra note 2, at 403 (“Constitutional debt limitations . . . are meant to address ‘a perceived institutional defect of legislatures: the inability to account for the future costs of present decisions to incur debt.’”) (quoting Stewart E. Sterk & Elizabeth S. Goldman, \textit{Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations}, 1991 Wis. L. Rev. 1301, 1306-10 (1991) (providing an early history of debt limitations)); \textit{see also}, Posner & Vermeule, supra note 31, at 1763 (describing “self-dealing by incumbent officials who choke off the channels of political change”).
\item[72] Id. at 404.
\item[73] Id. at 405; see Cole Lauterbach & Greg Bishop, \textit{Illinois’ pension debt grew more in one year than half of states’ entire budgets}, ILL. NEWS NETWORK (Oct. 12, 2017), https://www.illnews.org/news/state_politics/illinois-pension-debt-grew-more-in-one-year-than-half/article_1e9b33b4-ae8-11e7-b903-9bca6639e34.html [https://perma.cc/5L24-WHWB].
\item[74] ILL. CONST., art. XIII, § 5 (“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.”); \textit{see, e.g.}, ARIZ. CONST. art. XXIX, § 1(C) (barring legislative reductions to the statutory formula for pension benefit increases); MICH. CONST. art. IX, § 24 (protecting pension participants’ benefits accrued to date); N.M. CONST. art. XX, § 22 (recognizing that pensions give rise to vested property rights, protected by due process protections).
\item[75] Monahan, \textit{When a Promise is Not a Promise}, supra note 2, at 404.
\item[76] \textit{See} Alexander Volokh, \textit{Arizona Voters Approve Major Overhaul of Public Safety Officers’ Pensions}, REASON FOUND. (May 19, 2016) (Arizona voters approved Proposition 124, which effec-
IV. PRIVATE PENSION REFORM AND ERISA

ERISA greatly expanded the federal government’s role in regulating private-sector retirement plans and made the government the guarantor of private pensions by creating the Pension Benefit Guaranty Corporation (PBGC).

The Act was passed, at least in part, to prevent the government and employers from dipping into pension funds. As a result, the Act was created in such a way that it affords strong protections for pension participants in the form of federally promulgated regulations and statutory enforcement.

A. Defined Benefit vs. Defined Contribution Plans

ERISA plans can come in the form of defined benefit plans or defined contribution plans, though as time has passed, plans have increasingly trended toward defined contribution plans. Roughly starting in the 1980s, corporations began shifting private sector employees from defined benefit plans to defined contribution plans. Over the thirty years following the start of this movement, defined benefit plan membership plummeted.

Putting aside potential differences between public and private pensions, the shift from defined benefit to defined contribution plans has complicated pension funding plans because it interrupts the stream of assets flowing to the defined benefit employees. For this reason, private pensions have also had to problem-solve around underfunding and threats of insolvency.


78 See O’Reilly, supra note 8, at 227.


80 See Secunda & Maher, supra note 7, at 738.

81 See, MERRIAM-WEBSTER’S DICTIONARY OF LAW, supra note 7.

82 See WORKPLACE FLEXIBILITY 2010, GEORGETOWN UNIVERSITY LAW CENTER, A TIMELINE OF THE EVOLUTION OF RETIREMENT IN THE UNITED STATES, (2010) (In 1999, approximately 40% of private sector participants were covered by defined benefit plans, but by 2006, that number had been cut in half to only 20%), https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1049&context=legal [https://perma.cc/ZU5H-7UVV].

83 See Samuel Estreicher & Laurence Gold, The Shift from Defined Benefit Plans to Defined Contribution Plans, 11 LEWIS & CLARK L. REV. 331, 331–32 (2007) (“In 1975, [defined benefit] plans comprised one-third of all plans, enrolled just over two-thirds of all plan participants, accounted for just two-thirds of all pension plan assets and received just under two-thirds of all plan contributions. By 1998, the [defined benefit] sector comprised only one-twelfth of all plans, enrolled a bit under a third of plan participants, had just under half of all plan assets and received under a fifth of all plan contributions.”) (internal citations omitted).

84 Rob Kozlowski, MANAGING PENSION RISK: MORE FIRMS MAKE MOVE, BUT TARGETS SHIFTING,
B. Pension De-Risking

Pension de-risking, at a broad level, refers to any method a company undertakes to lessen the risk of operating a pension obligation.\(^{85}\) The process of converting ERISA Annuities into something else to offload the risk is considered “external” de-risking.\(^{86}\) There are two main ways to externally de-risk an ERISA plan: (1) convert the ERISA Annuity into a non-ERISA annuity, or (2) convert the ERISA Annuity into “an actuarially equivalent lump sum” to give to the beneficiary to use outside the confines of an ERISA-governed plan (hereinafter the non-ERISA lump sum).\(^{87}\) Generally, annuities deliver greater retirement security than lump sums.\(^{88}\)

Critics of de-risking point to the protections participants lose when their plans are converted into non-ERISA assets. Individuals who favor stricter regulations do so because they (1) believe a conversion from an ERISA Annuity into a non-ERISA Annuity creates an environment where the latter is less likely to be completed or (2) conversion from ERISA to non-ERISA Lump Sums will provide less security on the ERISA retirement promises.\(^{89}\) While these concerns highlight valid issues that arise when private pensions are removed from the carefully regulated context of ERISA, public pension participants would walk away no worse in that regard than before considering the scant level of regulations in the state pension context.

Because private plans under ERISA are subject to federal law, they are more heavily regulated than analogous plans in the state pension context.\(^{90}\) If the plan administrator for a private pension determines the sponsor is bankrupt or insolvent under ERISA, the PBGC can authorize the termination of that plan.\(^{91}\) When the PBGC terminates an insolvent or failing pension’s plan, it obtains the plan’s

\(^{85}\) Secunda & Maher, supra note 80, at 733.

\(^{86}\) Id. at 740 (“An external de-risk occurs when an entity other than the plan becomes the bearer of the risk associated with providing retirement income to the beneficiary.”).

\(^{87}\) Id. at 741.

\(^{88}\) Id. at 749–50. An annuity resembles a pension plan in that the participant is entitled to a series of scheduled payments for life. In contrast, the lump sum option provides less structure to ensure continued support. See id. at 753 (“The same problems that afflict [defined contribution] plans generally will afflict beneficiaries who receive Non-ERISA Lump Sums instead of ERISA Annuities: they will have problems in optimally saving, managing, and spending the lump sum over the course of their lifetime.”).

\(^{89}\) Id. at 747.

\(^{90}\) See O'Reilly, supra note 8.

\(^{91}\) Id. at 224; 29 U.S.C. § 1342 (2012).
assets,\textsuperscript{92} assumes responsibility for paying benefits to the terminated plan’s beneficiaries,\textsuperscript{93} and attempts to recover the plan’s shortfall from the employer that sponsored the plan.\textsuperscript{94}

Although pension plans under ERISA face challenges of their own, the increased regulation of funds and establishment of a third-party insurer, the PBGC, has boosted the overall health of private pensions.\textsuperscript{95}

V. VARIOUS REFORM PROPOSALS

Currently, most states appear unable to adequately fund pension benefits while managing governmental services.\textsuperscript{96} An overarching characteristic shared by most state reforms has been shifting risk associated with financing retirement benefits from the employers to the employees.\textsuperscript{97} Depending on the extent of states’ funding gaps and legal regimes, states have tried a variety of different reforms to bring their systems into line.

A. Short-Term Reforms

At this point, most changes to plans have been purely prospective,\textsuperscript{98} such as increasing taxes or cutting state expenditures.\textsuperscript{99} While these solutions do not pose any constitutional problems, they are troubling for two reasons. First, they are politically unappealing—no constituent wants their taxes raised or benefits slashed, and no politician wants to be credited for making an unpopular policy decision. Second, they are merely a band-aid to a much deeper problem. It is financially impossible to pay back $2.5 billion in debt vis-à-vis increasing taxes or reducing benefits. That said, these solutions are among the most commonly proposed because they are familiar tools to politicians, but the fact that politicians return to the same policy suggestions taken

\textsuperscript{92} 29 U.S.C. § 1342(d) (2012).
\textsuperscript{94} See, e.g., Pension Benefits Guar. Corp. v. Beverley, 404 F.3d 243 (4th Cir. 2005).
\textsuperscript{95} See O’Reilly, supra note 8, at 228.
\textsuperscript{96} Monahan, When a Promise is Not a Promise, supra note 2, at 356.
\textsuperscript{97} Brainard & Brown, supra note 9, at 6.
\textsuperscript{98} Id. at 5.
\textsuperscript{99} “While a few state retirement plans prior to the recent reforms did not have mandatory employee pension contributions, nearly all now have this requirement.” Id. at 3. Required contribution rates vary between plans and are often higher for those that do not contribute to federal Social Security. For example, “the median (mid-point) employee contribution rate in non-Social Security states is 8 percent of salary,” whereas employees “in plans that also provide Social Security coverage” pay only 5 to 6 percent. Id.
together with the state’s inability to make progress on this issue is telling. 100

Some states have reformed current and future pension participants’ benefits. As discussed in Part III, however, states like Illinois are legally constrained from implementing such restraints. The states that have changed current pensioners’ policies, however, have done so largely by reducing or eliminating cost-of-living adjustments (CO-LAs), 101 increasing age requirements for retirement, 102 and increasing the vesting period. 103

These reforms might raise the sufficient amount of funds needed for states to forestall default, but they do not solve the problem beyond a given fiscal year, and it would be politically infeasible to rely on such measures indefinitely. Further, prospective remedies alone would make little dent in closing funding gaps in states undergoing the worst pension crises.

B. Large-Scale, Systemic Reforms

A number of scholars have proposed larger reforms to restructure pensions to avoid complete insolvency. Terrance O’Reilly proposes that states should subject themselves to a set of federal regulations in return for federal financial support. 104 According to O’Reilly, federal financial support is nearly inevitable, which is why he proposes reformers act before that support comes in the form a bailout. 105 Another such proposal is to extend eligibility for bankruptcy to state governments. 106 The primary proponent of state-bankruptcy reform, David

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100 In his research on pragmatic decision-making, Nils Karlson explains that while pragmatic problem solving is often required in increasingly complex systems, its downsides often cause leaders to follow the status quo. In short, individuals are constrained by their limited ability to acquire and process information such that their mental capacity to consider policy reforms is quite narrow. Nils Karlson, The Limits of Pragmatism in Institutional Change, in KNOWLEDGE AND POLICY CHANGE 10 (Henrik Lindberg ed., 2013).

101 Id. at 4. (“Depending on how long a retiree lives, how much the COLA was reduced, and the actual rate of inflation, a COLA reduction can significantly reduce the value of a benefit over the remaining life of a retiree.”).

102 Id. (“Twenty-nine states increased retirement eligibility, affecting over 40 plans, and typically took the form of an increase in age, required years of employment, or a combination of both.”).

103 Id. (“Nine states passed laws that increased the vesting period for new employees, from 5 years to 10.”).

104 O’Reilly, supra note 8, at 183.

105 Id. at 187 (“A federal bailout of public plans will be controversial, but, in the end, some sort of federal financial support is likely.”); id. at 220 (“Timely action would allow the federal government to control the crisis and limit its ultimate financial exposure.”).

Skeel, argues that changing the bankruptcy process would allow states to reduce bond debt, which is nearly impossible outside of the bankruptcy context.\(^{107}\) Although the federal government would likely have to provide funds to states declaring bankruptcy, Skeel argues that bankruptcy restructuring would decidedly shorten the amount of funding when compared to a pure bailout.\(^{108}\)

Although both O’Reilly and Skeel present proposals that are amenable to states’ constitutional limits as well as far-reaching in how they address the pension deficit problem, they are less than ideal in that they would entail high adjustment costs. Both proposals require buy-in from both the state and federal government. The administrative and political challenges that would accompany these plans cannot be understated. Given that any changes, both at the state and federal levels, would originate in the legislature, there would need to be a high level of public support for the proposal. This in itself could be fatal to a sweeping measure that affects anything related to entitlement reform. Furthermore, the legislative and administrative measures would be vast. For these reasons, any proposal that relies on the federal government presents challenges that would need to be far outweighed by other policy rationales accompanying it.

VI. REFORMING PUBLIC PENSIONS THROUGH THIRD-PARTY ANNUITIZATION

State legislatures are not ideal candidates for handling pension liabilities. Under the current state pension regime in Illinois, state legislators have incentives to “kick the can down the road”\(^{109}\) by delaying scheduled payments, and do so by underestimating unfunded liabilities based on high-risk market growth assumptions.\(^{110}\) In other words, not only has the legislature largely determined its own timetable for repayment, but it has also hedged its bets by estimating its liabilities based on very optimistic market projections. The likelihood of this second calculation remaining true is unlikely and, therefore, only further serves to skew the State’s understanding of pension funds’ actual health.

\(^{107}\) Id.

\(^{108}\) David A. Skeel, Jr., State Bankruptcy from the Ground Up, in WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 211 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).


Taken together, these two observations—that legislatures are ill-suited to stick to their payment schedules and only account for positive market trends in calculating liabilities—suggest that legislatures, in general, are ill-suited to remain the primary entity responsible for handling state pensions. The problem is that the pension crisis has reached an apex at which legislators can no longer abdicate their responsibility without consequence.\textsuperscript{111} As such, legislators stand to gain by taking actions that will solve the problem, but the Illinois Supreme Court has made it clear they cannot do so by transgressing constitutional protections.

For the reasons outlined below, third-party annuitization through an open-market bid system will satisfy the political, legal, and financial needs that will embolden legislators to take action.

A. Third-Party Annuitization

Rather than fund and administer public employees’ pension funds, this Comment proposes that the State of Illinois pay large insurance companies to administer and monitor employees’ pension plans. Employees would be given the choice to opt out of their current plans, and would also be guaranteed, if they so choose, the same benefits, just funded through a different provider.\textsuperscript{112} For each employee who chooses third-party annuities, the State of Illinois would pay the insurance company for those annuities and in turn, give up its liability. The benefits of this plan are that it allows the state to reduce its liabilities while taking care of each employee’s interests. The reason why employees might opt for third-party annuitization is that, given the current climate of uncertainty around the State’s ability to pay out all employees’ pension funds in the near future, it offers a secure option with no cost to the employee.

B. Open-Market Bid System

Under this proposed plan, the State would solicit bids in accordance with the state’s Procurement Code\textsuperscript{113} procedures from insurance companies to administer and monitor employees’ pension plans. Employees would be given the choice to opt out of their current plans, and would also be guaranteed, if they so choose, the same benefits, just funded through a different provider. For each employee who chooses third-party annuities, the State of Illinois would pay the insurance company for those annuities and in turn, give up its liability. The benefits of this plan are that it allows the state to reduce its liabilities while taking care of each employee’s interests. The reason why employees might opt for third-party annuitization is that, given the current climate of uncertainty around the State’s ability to pay out all employees’ pension funds in the near future, it offers a secure option with no cost to the employee.

\textsuperscript{111} One could argue that the 2015 General Assembly’s passage of P.A. 98-599 evidences the sense of urgency legislators feel to reform the pension system.

\textsuperscript{112} Supposing that a state might also, in addition to transferring its liabilities to a third-party insurer, offer current pension participants the option to take the lump-sum (sometimes referred to as a “buy-out”), it remains unlikely participants would pursue this option. One criticism of the non-ERISA lump sum payments has been that it runs the risk of “robbing the beneficiary of value” that might result from poorly calculated actuarial estimates, and drastically higher tax rates.

\textsuperscript{113} See 30 ILCS § 500. Note that the current statutory scheme excludes pensions and would need to be amended.
companies that meet the State’s Insurance Code requirements.\textsuperscript{114} Although the State’s low credit rating and large amount of debt might weigh against insurance providers’ interest in taking on public employees’ plans, the State of Illinois boasts one of the most liberal insurance regulatory schemes, which might afford greater flexibility in crafting deals that are more favorable to the would-be insurers.\textsuperscript{115} Furthermore, by buying annuities through an open market bid system, the State would ensure it paid competitive rates while also preventing any self-dealing or mismanagement that has troubled pension plans in the past.\textsuperscript{116}

C. Pension De-Risking in the Public Context

A look at the protections that stand to be lost from de-risking in the private pension context highlight protections currently lacking in the public context such that they may serve as guideposts for what to include in an accompanying regulatory scheme. ERISA provisions require that pension schemes be funded in advance, thereby setting a statutorily regulated timeline for funding in addition to requiring that funding ultimately be fulfilled.\textsuperscript{117} While this feature of ERISA is something that stands to be lost by de-risking, there is nothing limiting states from implementing regulatory requirements along those lines. In fact, such requirements would be more politically tenable than implementing substantive rules in the current context because the suggestion is that it would not be the state legislature bound by the payment deadlines, but rather a third-party insurer that is less beholden to political pressure. As such, this would represent an efficient shifting of the risk from that of the state legislature to this third-party insurer.

D. The “Inside/Outside” Fallacy

One question that naturally arises in considering this proposal is whether it proposes a solution that relies on legislators taking action to fix the problem stemming from their own inaction.\textsuperscript{118} Broadly

\textsuperscript{114} See 215 ILCS §§ 5/1–185/35. Note that the current statutory scheme excludes pensions and would need to be amended.


\textsuperscript{116} See 90 Cong. Rec. H90 (daily ed. Oct. 29, 1997) (statement of Rep. Madigan) (stating that the Procurement Code was intended “to fetter out wrongdoing in all of the agencies of State Government in the area of procurement.”).

\textsuperscript{117} See Secunda & Maher, supra note 80, at 748.

\textsuperscript{118} See Posner & Vermeule, supra note 31, at 1745 (“The inside/outside fallacy occurs when the theorist equivocates between the external standpoint of an analyst of the constitutional order, such as a political scientist, and the internal standpoint of an actor within the system.”).
speaking, that is exactly what third-party annuitization entails, however, a closer look at the factors at play reveals that the previous non-starters that prevented legislators from acting are removed from this equation. Whereas previous reform proposals have either relied on short-term fixes that alienate at least part of legislators’ constituents (i.e., reducing pension benefits for recent hires), the current reform comes at no direct cost to the public. Instead, a third-party annuitization would provide all pension participants the same legal guarantees as their current pensions, but through a more stable provider. Meanwhile, for each pension participant who chooses to receive her benefits from a third-party insurer, the State has one less pension to fund.

Not only does third-party annuitization solve the problem of protecting pension participants’ benefits, but the opportunities it creates to alleviate and resolve the State’s pension funding gap is a politically appealing result with broader financial benefits. For example, residents of the State of Illinois have experienced record tax hikes since 2010, as state legislators have tried to reduce the rate at which the funding gap and other budget deficits have grown. By implementing third-party annuitization, legislators could not only tackle the largest financial issue facing the state, but also do so in a manner that helps their constituents now.

VII. CONCLUSION

Public pensions have been a symbol of stability for workers in Illinois and throughout the country for over a century. The government promised employees pensions in return for their life’s work. Generations of employees have contributed to the vitality of civic society through public work and are owed their dues—as a matter of public policy and law.

In order to find solutions to the problems facing public pensions today, reformers must learn from the past—the abuses that have led us here and the efforts to remediate that fell short. This Comment seeks to illustrate where Illinois stands as a matter of law and financial need. These two elements together serve as the necessary ingredients to develop a workable model for reforming the state system.

Rather than “re-invent the wheel,” reformers can look to successes achieved for similar purposes. Like the problem at hand here, private pensions have struggled to maintain secure funding. While the private pension context is not perfect, the federal structure of ERISA has, for the most part, been successful. The creation of the government backed insurance system, the PBGC, might serve as a model for a similar-type system to be created for states. The implementation of regulations to police this new third-party insurer appears to also present strong starting points for further research.

In addition to identifying the ways a public pension system might benefit from these proposals, similar considerations will need to be made for how they might raise new challenges such as increased burdens on the federal government or increased administrative costs in setting up the system.