

PENSION POINTERS



On the Verge of Default or Imminent Bankruptcy: Harvey's Perfect Storm

By Carolyn Welch Clifford
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Editor's Note: Pension Pointers is a column provided for our members who also serve on the Fire Pension Board.

When the First District's historic decision in *Board of Trustees of the City of Harvey Firefighters' Pension Fund*, 2017 IL App (1st) 153074, landed on August 4, 2017, Hurricane Harvey was still several weeks from landfall in Texas. The City of Harvey's financial storm, however, has been devastating for the residents of the City and its first responders for many years. The decision declares – for the very first time in Illinois – that a public pension fund is “on the verge of default or imminent bankruptcy” and comes on the heels of the First District's earlier decision this year in *Board of Trustees of Harvey Police Pension Fund*, 2017 IL App (1st) 153095 (April 10, 2017).

Factual Background of Harvey Police and Harvey Firefighters

A little under a decade ago, the City of Harvey entered into settlement agreements with its police and firefighter pension funds, promising to make contributions to the funds which it never made in some prior years and, in other years, had levied and collected, but never remitted, property taxes for the funds. What were once “IOUs” are now two separate judgments of over \$19 million collectively, as initially determined by the Cook County Circuit Court and now confirmed by the First District Appellate Court in *Harvey Police* and *Harvey Firefighters*.

Harvey Police

After years of failing to turn over taxes levied for its two pension funds, the Harvey Police Pension Fund sued the City of Harvey in 2006. The litigation led to a settlement agreement in 2008, in which the City agreed to pay the Fund \$551,079.83 in back property taxes. More importantly, the City further agreed it would annually levy taxes to provide the required employer contribution to the Fund as provided under the Illinois Pension Code. The City, however, failed to live up to the terms of the agreement and, in December 2010, the Fund filed a motion to compel enforcement of the settlement agreement.

With the assistance of an actuary, a determination of the amount of property taxes the City should have collected and remitted to the Fund from 2006 through 2014 was calculated. Although the City argued it only owed the most current fiscal year's contribution amount as calculated by the actuary, the circuit court agreed with the Fund, awarding it \$7,334,181.88 in employer contributions, as well as attorney fees.

The City appealed the judgment to the First District Appellate Court, arguing that the circuit court did not have the authority to enforce the provision relating to prior years' property taxes and challenging the method by which the damages were calculated. Specifically, the City contended that the circuit court's award was based

on statutory obligations not in effect on the date the settlement agreement was executed. However, the City had not raised this particular argument before the circuit court, and the appellate court determined that it was forfeited and would not be considered.

In short, the appellate court concluded the circuit court had jurisdiction to enforce the settlement agreement because the settlement agreement and original court order from the 2006 lawsuit provided the circuit court retained jurisdiction.

The sizable judgment in the case raises the inevitable question of how it will ever be collected, especially since it's not the only large monetary judgment facing the City of Harvey.

Harvey Firefighters

The City's Firefighters' Pension Fund, who originally sued the City in 1993 and also entered into a settlement agreement with the City for payment of back contributions of nearly \$1 million in 1995, filed a second lawsuit against the City in 2010. In 2015, the Cook County Circuit Court issued a final judgment in that litigation, awarding the Harvey Firefighters' Pension Fund over \$12 million in back employer contributions, plus 6% interest that began to accrue on the final judgment date.

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This case – like *Harvey Police* -- was also appealed to the First District Appellate Court in 2016. Here, in a lengthy, 86-page decision, the First District took the *Harvey Firefighters* case one step further than its decision in *Harvey Police*.

Until recently, Illinois courts have blocked traditional pathways to pension funds seeking relief from underfunding, citing the lack of constitutional protection to guaranteed funding (see *Board of Trustees of the Riverdale Police Pension Fund*, 2014 IL App (1st) 130416). Nevertheless, the *Harvey Police* decision, as well as another recent case, *Village of North Riverside v. Boron*, 2016 IL App (1st) 152687, indicated that Illinois appellate courts were willing to find other paths to enforce funding, including enforcement of contractual arrangements rooted in litigation seeking property taxes levied for pension purposes.

In *Harvey Firefighters*, however, the court circled back to the series of Illinois Supreme Court cases -- beginning with *People ex rel. Illinois Federation of Teachers v. Lindberg*, 60 Ill.2d 266 (1975), *McNamee v. State*, 173 Ill.2d 433 (1996), and *People ex rel. Sklodowski v. State*, 182 Ill.2d 220 (1998), and ending with the most recent decision *In re Pension Reform Litigation (Heaton v. Quinn)*, 2015 IL 118585 -- that have interpreted section 5 of the Illinois Constitution ("Pension Protection Clause"). In these cases, the Illinois Supreme Court recognized that the hope the drafters of the Illinois 1970 Constitution had -- that the Pension Protection Clause would induce proper funding of public pensions -- had been unfulfilled.

Nevertheless, the Illinois Supreme Court determined that it would require a finding that a pension fund is "on the verge of default or imminent bankruptcy" such that "benefits are in immediate danger of being diminished" before the courts could apply this constitutional protection to insure funding.

As the First District Appellate Court explained in *Harvey Firefighters*:

Although it is true that pension funds do not have a right to a specific level of funding, the framers of the Illinois Constitution

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intended to put the municipalities on notice [with the addition of the Pension Protection Clause] that, if they completely abandoned their pension obligations, then the pensioners would be able to sustain a constitutional claim.

Because neither the Illinois Constitution nor the Illinois Supreme Court have defined what qualifies as "on the verge of default or imminent bankruptcy," the appellate court pointed to a series of factors in *Harvey Firefighters* to come to the historic conclusion that the plaintiffs had supported their constitutional claim:

- **The Fund's financial history revealed that while the City often paid little to no contributions to the Fund from as early as 2005, the Fund paid out millions of dollars in benefits during the same timeframe.** The court noted that if the trend continued, the Fund would be paying out increasing benefits without receiving any contributions from the City. Essentially, the Fund has been surviving solely on active firefighter contributions and interest on the remaining invested assets. The court opined that the Fund is in a "precarious position."
- **Evidence regarding the City's poor financial condition depicted a series of failures and questionable practices.** The appellate court cited the City's failure to file annual financial reports or audits. The court noted specific concerns regarding mismanagement and improprieties with payments to elected officials and their family members, as well as a Securities and Exchange Commission complaint regarding misuse of bond proceeds.

- **The City lacks accountability now and in the past as far as correcting its handling of its local pension crisis.** Notably, the court pointed to the fact that the City had contributed less than ten percent of the annual actuarial requirement to its firefighters' pension fund in six out of the nine years examined from 2005 to 2014. Expert testimony presented by the *Harvey Firefighters' Pension Fund* opined that the Fund was "well on its way to insolvency."

In determining that the conditions established a valid and enforceable constitutional right to funding, the court concluded:

Combining the ever-decreasing assets in the Pension Fund, the consistent lack of contributions, and the lack of evidence to support a changing of financial habits by *Harvey*, this court is convinced that the Pension Fund is on the verge of default. **To be clear, it is not merely the financial status of the Pension Fund that leads this court to this finding, and we understand that we are the first court to find in this manner.** However, the compounding nature of the situation – including the precarious financial position of the Pension Fund based on multiple experts in relevant fields, the constant declarations by *Harvey* that it has not contributed to the Pension Fund's poor financial condition, and the continued lack of financial responsibility shown by *Harvey* over a significant period of time – has convinced this court that **this case is a perfect example of a fund on the verge of default.** [emphasis added]

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In short, the court determined:

- **The City violated the Fund' statutory right to funding.** However, the court noted that as long as the City is levying an amount that would produce the annual actuarially mandated contribution, the City would be meeting its obligations under the Illinois Pension Code (40 ILCS 5/4-118).
- **The City breached the 1996 settlement agreement,** in which it had contractually agreed to make its employer contributions to the Fund in accordance with its statutory obligations under the Illinois Pension Code.
- **The trial court correctly calculated the damages to the Fund of \$11,561,117,** which represents an accumulation of damages for 2005 through 2014. In making this award of monetary damages, the appellate court noted that the lower court had not exceeded its authority under the Illinois Pension Code.
- **The City's affirmative defenses of separation of powers and laches were correctly rejected by the trial court.** On this issue, the court recognized that while the City has discretion under the Illinois Pension Code in annually levying taxes for the Fund, the applicable statute also requires the City to enact a levy for the Fund. In exercising its discretion, the court concluded that the City had

abused it. Additionally, the factual history in this matter did not support a conclusion that the City fulfilled the requirements for *laches*, as there was nothing to suggest that the City was "unknowingly" accruing liability to the Fund. Rather, the facts showed that the City was knowingly avoiding its funding duties.

- **Most importantly, the Fund is on the verge of default "due to Harvey's blatant disregard of the Pension Fund for many years and the severe lack of any financial responsibility shown by Harvey, which has substantially impaired the Fund to the point that the firefighters' pension rights will be diminished in the near future."**

The Implications for the City of Harvey

A review of the City's last audit for the fiscal year ending April 30, 2016, indicates that, while the City should have contributed over \$1.2 million to the Police Pension Fund in 2016, the City actually contributed only \$110,219. Similarly, the actuarially determined contribution to the Firefighters' Pension Fund in 2016 was \$2.4 million, but the City contributed only \$398,566. As of the fiscal year ending April 30, 2016, the Police Pension Fund pays out over \$1.5 million in benefits annually, while the Firefighters' Pension Fund's annual benefit payroll is over \$2 million annually.

In fact, the City's proposed levy for the fiscal year 2016-2017 would have provided for \$1.16 million to the police pension and

\$2.64 million to the fire pension; however, sources at the Cook County's Clerk's office indicate the levy was never filed.

The court observed in *Harvey Firefighters* that, "In essence, Harvey is robbing Peter to pay Paul, but what happens when Peter retires?" It is an important question, and unfortunately, at this point, there are no good answers for the City of Harvey and its two pension funds.

The Takeways for Illinois Municipalities and Public Pension Funds

For villages, cities and fire protection districts, the primary takeaway from the *Harvey Police* and *Harvey Firefighters* cases should be that choosing to underfund – or failing to fund – their fire and police pensions will result in quickly skyrocketing debt, which is now more likely to turn into litigation and subsequent judgments against them.

For fire and police pension funds who previously have been hesitant to pursue costly litigation, the *Harvey Police* and *Harvey Firefighters* cases open the possibility that funding litigation may be more favorably received by the courts than previously believed – even if the resulting judgments appear to be simply moral victories.

And finally, "on the verge of default or imminent bankruptcy" now has a court-determined definition, courtesy of the City of Harvey. ■



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