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**IPPFA SEMINAR**

**RETIREMENT SPIKES:**

**How I spent my last day on the job,**

**or**

**The Golden Spike v. salary Attached to Rank**

What applies towards pensions? How to make it fit the Code.

Presented by:

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**EARLY RETIREMENT INCENTIVES  
AND THEIR EFFECT ON PENSION BOARDS**

**I. INTRODUCTION**

Recently, some Illinois municipalities have promulgated ordinances or entered into collective bargaining agreements (CBA) that encourage police officers or firefighters to retire. These types of provisions are frequently referred to as "pension or retirement spikes." The purposes of such ordinances or CBAs are to free up positions in the police or fire department, reduce budgets or reward long-term service. Usually, the ordinance or CBA provides that employees who are eligible for such early retirement, will receive additional salary increases. Sometimes these inducements are disguised as "longevity" pay increases. Such ordinances or CBAs can impact the pension board, both from a legal standpoint and an actuarial standpoint. In addition, the Illinois Department of Insurance has voiced some concerns about such ordinances or CBAs. This handout will explore these various ramifications.

**II. RELEVANT STATUTORY PROVISIONS**

Under Article 3 (pertaining to suburban and downstate police pension boards) and Article 4 (pertaining to suburban and downstate firefighter pension boards) retirement pensions are based upon a percentage of salary. Under 40 ILCS 5/3-125.1, a police officer's salary is defined as follows:

"Salary" means the annual salary, including longevity, attached to the police officer's rank, as established by the municipality's appropriation ordinance, including any compensation for overtime which is included in the salary so established, but excluding any "overtime pay," "holiday pay," "bonus pay," "merit pay," or any other cash benefit not included in the salary so established.

The language in both provisions is identical.

**III. DEPARTMENT OF INSURANCE REGULATIONS**

The Illinois Department of Insurance has promulgated regulations further defining the term "salary." These regulations provide:

**A. Section 6302.40. Non Salary Compensation**

For purposes of calculating pension contributions and pension benefits, the following categories of pay shall not be considered compensation:

- a) Accumulated Unused Time  
Compensation for unused accumulated vacation, sick or personal time earned during employment, regardless of whether the compensation is received during employment or after termination.
  
- b) Awards  
Compensation for an extraordinary deed or accomplishment, which is not recurring in nature.
  
- c) Automobile Allowance  
Compensation for the use of the employee's personal automobile.
  
- d) Food Allowance  
Compensation for the purchase of meals while performing the duties required.
  
- e) Housing Allowance  
Compensation received for the purpose of providing housing, in whole or in part. The method of providing the housing, such as renting or purchasing, is irrelevant.

- f) Merit Pay  
Compensation which is neither fixed in amount nor determined by a reviewing bargaining agreement or pa plan, nor added into the salary for determining future increases.
  
- g) Overtime Pay  
Compensation paid for working more than the regular hours, which is already included in the regular salary attached to that rank or class.
  
- h) Shift Differential  
Compensation for working a second or third shift, in addition to the salary attached to that rank or class.
  
- i) Temporary Pay  
Compensation received for temporarily performing the duties of a higher rank or specialty rank position shall not be considered salary unless and until this compensation has been received continually for one full year.
  
- j) Uniform Allowance  
Compensation received as reimbursement or payment for the purchase of necessary uniform and equipment for use in the performance of the required duties. This compensation may be paid as reimbursement or as a fixed amount, regardless or the actual amount expended.

**B. Section 6302.35 Salary for Pension Purposes**

All salary as defined in Section 6302.30 of this Part, shall be used in pension computations, for purposes of determining the correct amount of employee contributions. The following types of pay are considered salary, in accordance with the definition in Section 6302.30:

a) Base Pay

The basic salary attached to the rank which is specified in the bargaining contract, municipal pay plan or any other document which establishes salary:

b) Educational Pay

Additional compensation for attaining certain levels of academic and professional training, such as an associate or bachelor's degree or attainment of firefighters certification or firearm certification or any other pay given for designated educational achievement.

c) Holiday Pay

Additional compensation paid regardless of whether the employee must work on the holiday unless there is an option, such as time off in lieu of cash compensation.

d) Longevity

Additional pay received after the employee has attained a specified number of years of service. This pay may be received with regular salary or in one or more lump sum payments during the year. When paid in a lump sum, the amount should be prorated to determine the monthly equivalent to compute all pension contributions and benefits.

e) Overtime Pay

Compensation for time worked beyond the regular work hours, which is already included in the regular salary attached to that rank or class.

Compensation for services performed in positions beyond the basic rank, such as detective, juvenile officer, special instructor, shift commander, training officer, chief, emergency medical technician, paramedic, range officer or mechanic.

f) Temporary Pay

Compensation received for temporarily performing the duties of a higher rank or specialty rank. This is to be considered salary only if the temporary position has lasted for a continuous period of no more than one year. After temporary pay has been received for one continuous year of service in that position, the amount is considered attached to the rank and then becomes salary for purposes of pension computation.

**IV. THE ISSUE**

With these statutory and regulatory provisions at hand, the issue becomes whether or not a police officer or firefighter who receives a salary increase to encourage his or her early retirement can have that increase included as a part of salary for retirement pension purposes? To date, no Illinois court decisions have directly addressed this issue.

**V. POSITION OF THE DEPARTMENT OF INSURANCE**

The Public Pension Division of the Illinois Department of Insurance, the agency that regulates police and firefighter pension boards, was initially critical of such early retirement benefits. In a letter dated October 4, 1994, the Department expressed concerns about an ordinance one municipality enacted that allowed qualifying police officers to have their annual salary increased by \$7,000.00 for longevity if they opted for early retirement.

In that letter, the Department stated to the pension board:

"Whether considered as a "bonus" excluded from the definition of salary, or as an amount paid for the commitment to retire rather than for services rendered, we believe such inducements should not be considered as salary for purposes of calculating pension benefits."

In a letter dated January 11, 1995 to a fire department chief, the Department expressed the following:

"We are further concerned that such inducements are not commensurate with salary and contribution history, and that their effect would be to artificially increase pension fund liabilities in an actuarially unsound manner."

The Department went on to indicate in that letter that the issue of early retirement inducements should be a matter that should be considered by the Illinois legislature on the basis of sound financial data.

However, in a recent letter to a Firefighter's Union, the Department indicated that a pension spike that was proposed by the Union for a CBA was not a violation of the Pension Code or the Department's Rules because it was negotiated as a "longevity increase" and was not an "inducement" to retire.

## **VI. DISCUSSION**

Obviously, a pension board has no control over the ordinances that its municipality may enact or the CBAs that were negotiated. However, in the case of early retirement ordinances or CBAs that can affect pension fund assets and retirement benefits, the pension board has to be prepared to take a position. Does it pay a retirement pension based upon the increased salary under the early retirement ordinance or CBA or not?

The pension board faces a dilemma either way. If it grants the retirement pension based upon the increased salary, the Department of Insurance or other participants or beneficiaries may take legal action. If the pension board denies a retirement pension on the increased salary, the pension board

faces litigation by the applicant and, no doubt, strained relations with the municipality that enacted the ordinance, or the Union that negotiated the CBA.

### 1. Illinois Case Law/Decisions

As indicated above, there are no Illinois cases directly on point. There are however Illinois cases that examine what does or does not constitute salary. These cases provide some insight to this retirement incentive issue.

In Jahn vs City of Woodstock, 99 Ill.App.3d 206, 425 N.E.2d 490 (1981), the issue was whether a police officer receiving a disability pension was entitled to receive insurance premiums from the municipality in addition to his disability pension. The Second District Appellate Court said no. The court reached its decision by examining the definition of "salary" under Article 3 of the Pension Code. Referring to the definition of salary found in '3-125(2) the court reasoned:

Because no provision for fringe benefits was provided in this section, that in itself is an indication that the legislature intended to exclude fringe benefits from the term "salary." Jahn, supra, 425 N.E.2d 492.

The court went on to note that "salary" is normally defined as a fixed annual or a periodic payment, rather than a fringe benefit.

In Park Ridge Fireman's Pension Fund vs Department of Insurance, 109 Ill.App.3d 919, 441 N.E.2d 107 (1982), the court examined a situation involving a \$700.00 annual payment to firefighters that was paid as an incentive for becoming certified and maintaining qualifications as a paramedic. It was held by the appellate court that the \$700.00 annual payment was in fact a part of salary for pension contribution purposes. According to the court, "salary" is defined as: "a fixed, annual, periodical amount payable for services and depending upon the time of employment and not the amount of services rendered." (441 N.E.2d at 109). In contrast, a "bonus" was defined as: "money given in addition to the usual compensation; a premium or extra or, irregular remuneration in consideration of offices performed or to encourage their performance or, an addition to salary or wages normally paid." (441 N.E.2d at 109).

In Peo. ex rel. Campbell vs Swedeberg, 351 Ill.App.121, 113 N.E.2d 849 (1953) the appellate court held that a salary increase, one month before retirement would not be included as a part of salary for computation of a retirement pension. In that case the court reasoned:

If a recipient, should receive an increase in rank or a pay increase a short time before he should receive an increased pension; he should have at least partly earned it. (Campbell, supra, 113 N.E.2d at 851).

In Oak Brook Police Pension Board vs Department of Insurance, 42 Ill.App.3d 155, 356 N.E.2d 171 (1976), it was held that "merit increases" that were added to the salary of police officers and firefighters were subject to pension deductions and that such increases differed from "merit pay."

In City of DeKalb vs. International Association of Firefighters, 182 Ill.App.3d 367, 538 N.E.2d 867 (1989), it was held that a municipality could not pay supplemental pension benefits (disability) to a disabled firefighter because such payments alter the provisions of the Illinois Pension Code and are against public policy.

In Rhoads vs. Board of Trustees of the Calumet Police Pension Fund, 293 Ill.App.3d 1070, 689 N.E.2d 266 (1997) the court held that a municipality's attempt to increase a police chief's salary retroactively, by increasing the salary for police chief ten (10) months after he left the position to seek disability pension benefits was not the true "salary" attached to the chief's rank pursuant to §5/3-125.1 of the Pension Code.

In an interest arbitration award, rendered by the Arbitrator Marvin Hill, Jr. pursuant to Illinois Public Labor Relations Act (IPLRA) in City of Belleville and Belleville Firefighters' Association, IAFF Local 53, S-MA-99-193 (2000), Arbitrator Hill was faced with a proposal by a Union to relinquish an employee's last year of vacation leave in exchange for short term salary increases, which would increase a firefighters' "salary" should he retire during the time period. The City refused to bargain over the issue contending that it was unlawful. While stopping short of declaring the Union's proposal "unlawful" Arbitrator Hill adopted the City's position.

These cases are by no means dispositive of the issue concerning increases in salary as an early retirement incentive. However, there is an indication as to what is considered a part of salary and what is not. Under Illinois law it is not the terminology that counts - it is what the courts consider to be the actual legal character of the compensation. Park Ridge Firemen's Pension Fund vs Department of Insurance, 441 N.E.2d at 109. If these cases are any indication, Illinois courts may not consider pay increases to promote early retirement as a part of salary.

## **2. Other Jurisdictions**

One court has specifically addressed the issue of early retirement incentives. In Boston Association of School Administrations vs Boston Retirement Board, 419 N.E.2d 277 (1981), the Supreme Court of Massachusetts ruled that early retirement payments would not be considered a part of base salary for purposes of computing pension benefits. The Massachusetts court reasoned that money paid out to induce early retirement is not a part of regular compensation but operates more as a bonus. A similar result was reached in Hessel vs New York City Retirement System, 308 N.E.2d 688 (1974), where it was held that termination payments were not a part of retirement computations.

One state court case has allowed termination payments to be included in the computation of retirement benefits. In Washington Association of County Officials vs Washington Public Employee Retirement System, 575 P.2d 230 (1978), the Supreme Court of the State of Washington ruled that the pension fund's twenty-five year practice of including termination pay as a part of retirement benefits gave rise to a contractual right to receive a higher pension. The court noted that the practice of including these additional benefits existed since 1952, although no formal regulation existed. Once this practice was established by the pension fund, its members had a vested right to the continuance of that practice. Thus, this case turned on the pension fund's longstanding practice rather than whether the computation was legally correct.

In construing any early retirement incentive ordinance Illinois courts could look to the above cases from other states. The majority view would seem to be that lump sum one-time payments may not be includable as a part of final salary for pension payments. See also Massachusetts Teachers Association vs Teachers Retirement Board, 419 N.E.2d 282 (1981); Lansing Firefighters Association vs City of Lansing Policemen's and Firemen's Retirement System, 282 N.W.2d 346 (1979); Gilmore vs Burks, 325 So.2d 455 (1984).

### **3. Actuarial Considerations**

From an actuarial standpoint computing retirement benefits on an additional amount paid as a retirement incentive will have an adverse actuarial impact. If the retiree's salary is increased \$5,000.00 to induce his early retirement, the pension fund has received no contributions for this increase. As such a pension fund's total actuarial liability and unfunded liability would increase and the funded ratio would decrease under an early retirement ordinance.

## **VII. RECOMMENDATION**

In order to comply with the Department of Insurance Rules and Regulations, the Illinois Pension Code, as well as the case law from Illinois and other jurisdictions, the Pension Board should consider the following:

- 1) Salary to include longevity pay, must be approved through the municipality's appropriation ordinance or collective bargaining agreement;
- 2) The "salary" including longevity must be fixed, meaning a payment in a predetermined amount that can be determined by the appropriation ordinance or collective bargaining agreement;
- 3) The longevity pay must be a scheduled payment, paid either annually, quarterly, monthly or other basis;
- 4) The longevity pay must be additional pay received after the employee has attained a specified number of years of service;
- 5) Pension contributions must be withheld on any amounts payable to officers as longevity pay in the amount prescribed by statute;
- 6) The "longevity" pay must not be pay for extraordinary deeds or accomplishments;
- 7) The "longevity" pay must not be tied to an incentive or commitment to retire;
- 8) The "longevity" pay should be available to all department members that are members of the Pension Fund, that are not

covered by a Collective Bargaining Agreement;

- 9) The actuarial impact of the "longevity" pay upon the Pension Fund should be considered by all parties;
- 10) The "longevity" pay created by ordinance or CBA should not be labeled "early retirement incentive" program.

### **VIII. CONCLUSION**

As can be seen by the above, there are a number of problems from a Pension Fund's standpoint with regard to the imposition of an early retirement ordinance that increases annual retirement benefits. A pension board could be involved in litigation with the Department of Insurance, participants, beneficiaries or the municipality itself, depending upon whether or not the pension board follows the ordinance or Collective Bargaining Agreement.

It is strongly suggested that before a pension board decides to honor any early retirement ordinance all of the legal and financial ramifications are explored.

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