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## Last in Line

BY MARK A. BOGDANOWICZ

### Legal Rights and Economic Realities

#### The Uncertain State of Public Pensions After Stockton

Once an irregular occurrence, municipal bankruptcies have been at the forefront of bankruptcy headlines in recent years. A key economic factor in chapter 9 cases is the need for municipalities to restructure compensation obligations to their employees, most notably future pension obligations. But while the ability of municipalities to reject collective-bargaining agreements with public employees has been tested,<sup>1</sup> the ability of municipalities to impair future pension obligation has not — at least, not explicitly.

In addressing the ability of the city of Detroit to file a chapter 9 case, Hon. **Steven W. Rhodes** of the U.S. Bankruptcy Court for the Eastern District of Michigan concluded that the city could impair pension obligations that are owed to public employees, notwithstanding the provisions of the Michigan State Constitution, which provides that the accrued financial benefits of a state or municipal retirement system are a contractual obligation that cannot be diminished or impaired.<sup>2</sup> Before this issue could be determined on appeal, the parties settled.

In October 2014, the treatment of public pensions in municipal bankruptcies was addressed as part of the confirmation of the first amended adjustment plan filed by the city of Stockton. Hon. **Christopher M. Klein** of the U.S. Bankruptcy Court for the Eastern District of California joined in the ultimate conclusion reached by Judge Rhodes — namely, that municipal debtors have the right to impair public pension rights, notwithstanding the limitations imposed by § 903 of the Bankruptcy Code, which provides that chapter 9 “does not limit or impair the power of a State to control, by leg-

islation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise.” In essence, the ability to impair public pensions as part of a chapter 9 proceeding may not necessarily dictate the path that a municipal debtor elects to take in the exercise of its economic judgment. This article will address the factual and legal issues raised in the *Stockton* matter, the position of each of the relevant parties, the court’s ultimate decision and Stockton’s future ramifications.

#### Background: Litigation in Stockton

After an evidentiary confirmation hearing held on July 8, 2014, Judge Klein invited additional briefings on the question of the status and implications of the California Public Employees’ Retirement System (CalPERS), given the objection raised by the Franklin California High Yield Municipal Fund and Franklin High Yield Tax-Free Income Fund (collectively, the “Franklin parties”). The Franklin parties argued that the proposed chapter 9 readjustment plan was not confirmable, principally because the non-impairment of public pensions constitutes “unfair discrimination” in violation of §§ 901 and 1123(a)(5) of the Bankruptcy Code. On Oct. 1, 2014, the court heard closing arguments on the confirmation of the proposed plan, including the issues surrounding whether the city had the legal ability to impair the pension benefits administered by CalPERS and the legal and economic consequences that such an impairment would bring about.

#### Stockton and CalPERS’ Position as to the Treatment of Public Pensions in Chapter 9

##### CalPERS’s Response to the Court’s Concerns

In addressing the questions raised by the court during the July 8, 2014, hearing, CalPERS first



**Mark A. Bogdanowicz**  
Howard & Howard  
Attorneys, PLLC  
Peoria, Ill.

Mark Bogdanowicz is a shareholder with Howard and Howard Attorneys, PLLC in Peoria, Ill. He also serves as a coordinating editor for the ABI Journal and is co-chair of ABI’s Labor and Employment Committee.

1 See *In re City of Vallejo*, 432 B.R. 262 (E.D. Cal. 2010) (holding that § 365, as interpreted by *Bildisco*, controlled whether public sector labor agreements could be rejected in chapter 9 cases).

2 See *City of Detroit*, 504 B.R. 97, 150-61 (Bankr. E.D. Mich. 2013). Judge Rhodes participated in an ABI podcast in December 2014 with ABI Fall 2014 Resident Scholar **Lois R. Lupica** (University of Maine School of Law; Portland, Maine). The 35-minute video is available at [www.abi.org/newsroom/videos](http://www.abi.org/newsroom/videos).

argued that it is an agency of the state of California exercising a core governmental function. As to the identity of CalPERS as an arm of the state, it cited section 20002 of the California Government Code and several state court decisions referring to CalPERS as a state agency.<sup>3</sup> CalPERS noted that this treatment is consistent with the federalism concerns giving rise to the exemption of public pension plans from titles I and IV of the Employee Retirement Income Security Act of 1974 (ERISA) and the body of federal case law acknowledging this exemption. Finally, citing two recent California federal district court decisions, CalPERS argued that it exercises a core governmental function because it “addresses matters of statewide rather than local or municipal concern — the promotion of public service and providing long-term financial security to state and municipal employees in the State of California.”<sup>4</sup> Based on the foregoing, CalPERS posited that § 903 of the Bankruptcy Code applies to CalPERS’s relationship with municipal debtors and precludes the modification of this relationship through a bankruptcy case proceeding under chapter 9.

CalPERS argued that pursuant to section 20487 of the California Public Employees’ Retirement Law (PERL), any rejection of public pension obligations owed to CalPERS would render Stockton ineligible for chapter 9 relief. PERL states, in relevant part, that “[n]otwithstanding any other provision of law, no contracting agency or public agency that becomes the subject of a case under the bankruptcy provisions of chapter 9 ... shall reject any contract or agreement between that agency and the board pursuant to section 365 [of the Bankruptcy Code] or any other similar provision of law.”<sup>5</sup> CalPERS observed that this state statute provides the conditions that are placed upon a municipality’s eligibility for chapter 9 relief and, pointing to legislative history, that the state may withdraw its consent to participation at any time during the case.<sup>6</sup>

CalPERS contended that the relationship between the retirement system and Stockton was not an “executory contract” within the meaning of § 365. Since state law prohibits CalPERS from failing to perform (even upon a prior breach by a municipality), the relationship would not fall within the prevailing definition of an executory contract — namely that failure by either side to the agreement would constitute a material breach that would excuse the performance of the other.<sup>7</sup>

CalPERS argued that it would be entitled to a non-avoidable statutory lien on Stockton’s assets in the event that Stockton elected to withdraw and either move to an alternate provider or discontinue pensions to municipal employees. Section 20574 of the PERL grants CalPERS “a lien on the assets of a terminated contract agency, subject only to a prior lien for wages, in an amount equal to the actuarially determined deficit in funding for earned benefits of the employee members of the agency, interest, and collection costs.” However, as conceded by CalPERS, the statute does not explicitly state when this statutory lien arises. Turning to legislative history and the purpose of making the lien effective

in bankruptcy, CalPERS argued that the lien attaches to a municipality’s assets as soon as the municipality joins CalPERS.<sup>8</sup> As such, the statutory lien would not run afoul of § 545(1) of the Bankruptcy Code, which permits the avoidance of liens triggered by, *inter alia*, the bankruptcy or insolvency of a debtor.

**From the vantage point of public pensions, where do we go “after” Stockton? The trajectory of that path remains highly uncertain as the Franklin parties filed a notice of appeal as to the bankruptcy court’s confirmation of the city’s adjustment plan.**

### **City of Stockton’s Response to the Court’s Concerns**

The focus of the city’s response was not upon the question of whether or not the city could legally reject or otherwise impair its pension obligations. Instead, the thrust of the city’s post-hearing briefs<sup>9</sup> was upon the economic consequences flowing from such an action and the lack of any viable economic alternatives to CalPERS. As noted by the city, “[t]he practical question facing the City is not whether it can legally impair CalPERS, but whether it can, and should, further impair its employees and retirees.”<sup>10</sup>

The city argued that the chapter 9 plan before the court already contained substantial concessions from city employees. The city noted that it had already wiped out retiree medical benefits and had negotiated collective-bargaining agreements with lower compensation and increased employee pension contributions.<sup>11</sup> Prior to the filing of Stockton’s chapter 9 petition, the city had reduced its total work-time workforce by approximately 25 percent and reduced employee compensation.<sup>12</sup> The reductions made in other forms of employee compensation (*i.e.*, payments today and health benefits tomorrow) resulted in cost savings to the city going forward. Moreover, the city argued that such reductions have the net effect of indirectly reducing pension obligations. Based on testimony from city personal and expert witnesses, the city argued that further reductions, in the form of pension reductions, would result in a mass exodus of experienced key employees who were necessary for the city’s public health and safety and an inability to attract replacements.

While there were alternatives to providing pensions through CalPERS, the city argued that these alternatives were not practically viable under the facts of the case. The city asserted that it would take between six months to one year to establish and implement its own pension system. During that time, it would need to incur the start-up costs

8 *Id.* at 26.

9 City’s Supplemental Brief in Support of Confirmation of the First Amended Plan of Adjustment, as Modified (Aug. 8, 2014) [Docket No. 1657] (“City Supp. Br.”), and City’s Supplemental Reply Brief in Support of Confirmation of the First Amended Plan of Adjustment, as Modified (Aug. 8, 2014) [Docket No. 1712].

10 City Supp. Br. at 19.

11 *Id.* at 18.

12 *Id.* at 19.

3 CalPERS’ Supplemental Brief in Support of Confirmation of the City of Stockton’s First Amended Plan of Adjustment [Docket No. 1662] (“CalPERS Supp. Br.”) at 6.

4 CalPERS Supp. Br. at 8.

5 Cal. Gov. Code § 20487.

6 CalPERS Supp. Br. at 31 (citing H.R. Rep. No. 94-686, at 8, reprinted in 197 U.S.C.A.N. 539, 454).

7 *Id.* at 30 (quoting *Markus & Millichap Inc. v. Murple Ltd. (In re Murple)*, 868 F.2d 1129, 1130 (9th Cir. 1989)).

that are associated with hiring personnel and setting up a system to administer contributions and benefits. After doing so, it would incur the continued cost of administering the system, all without the economies of scale enjoyed by statewide systems such as CalPERS.<sup>13</sup> The city also argued that as the new system would begin with no assets,<sup>14</sup> it would need to either provide lower benefits or demand higher employee contributions than those under the present pension system.<sup>15</sup>

The city concluded that migrating the Stockton pension benefits to other public — or even private — alternatives would likewise be economically inferior to maintaining the status quo with CalPERS. In response to the court’s question about possibly joining the retirement system established by San Joaquin County, the city argued that this option lies within the exclusive control of the county and posited that it would be unlikely that San Joaquin would be willing to accept Stockton on the heels of a default to CalPERS.<sup>16</sup> With regard to private pension administrators, the city pointed to the absence of evidence in the record of any city in California doing so, the notable exception being San Clemente, which had recently abandoned this option in favor of joining CalPERS.<sup>17</sup> The city argued that it was unlikely that a private pension administrator would be able to provide the same level of benefits at a lower cost on the grounds that “its profit margin would be an added cost that does not exist for public systems.”<sup>18</sup>

## The Court’s Holding as to the Potential Treatment of CalPERS in a Chapter 9 Case

In the context of ruling on an objection to Stockton’s chapter 9 plan, the court considered what the alternatives would be to a plan that leaves pension benefits administered by CalPERS unaltered — namely, whether applicable bankruptcy law permits the alteration of Stockton’s relationship with CalPERS. In doing so, the court began with the starting premise that pension rights are a bundle of contracts.<sup>19</sup> From there, the court turned to how the rejection process in a private setting generally impacts contract rights — *e.g.*, the renegotiation of leases that are above market under the threat of rejection under § 365.

The court rejected CalPERS’s argument regarding the limitations upon assumption and rejection purportedly created under section 20487 of the PERL. Since § 901 of the Bankruptcy Code incorporates § 365 into chapter 9 cases and because § 106(a) of the Code abrogates assertions of sovereign immunity with respect to § 365, the court concluded that this provision of California state law is invalid in the face of the Supremacy Clause of the U.S. Constitution. Relying on authority from *Mission Independent School District*,<sup>20</sup> the court held that § 365 may be implemented with respect to Stockton’s contract with CalPERS.

<sup>13</sup> *Id.* at 10.

<sup>14</sup> Based on the exchange between counsel for CalPERS and the court during oral arguments, it is unclear whether the absence of assets at the commencement of a substitute system is, practically speaking, the likely outcome or whether it is a necessary outcome. (See Tr. at 19-21.)

<sup>15</sup> *Id.* at 9.

<sup>16</sup> *Id.* at 12.

<sup>17</sup> *Id.* at 13.

<sup>18</sup> *Id.*

<sup>19</sup> Judge Klein’s ruling as to CalPERS’s claim is found at pp. 64-86 of the Transcript of Proceedings Held on Wednesday, Oct. 1, 2014, at 10 a.m.

<sup>20</sup> 116 F.2d 175 (5th Cir. 1940).

As a corollary, Judge Klein addressed the impact of a statutory lien that purportedly arises in the event that a municipality terminates its arrangement with CalPERS.<sup>21</sup> In examining the legislative history of the statute giving rise to the lien, the court concluded that it was enacted in response to the possible risk that is associated with filing a chapter 9 case. Moreover, the court concluded that the lien only becomes effective when a municipality has become insolvent, and therefore voidable pursuant to § 545(1)(D) of the Bankruptcy Code.

Notably, the court indirectly addressed the potential limits imposed by §§ 903 and 904 of the Bankruptcy Code. The court observed that CalPERS functions as a collection and investment agent for the individuals who become entitled to a pension. While not explicitly saying so, the court seemed to be strongly suggesting that CalPERS is not a “state” within the meaning of § 903. The court considered whether the employer/employee relationship falls within the “political or governmental powers” of Stockton within the meaning of §§ 903 and 904. Since there were non-public pension alternatives available to Stockton (*i.e.*, contracting with a private entity or electing not to provide pensions at all), the court concluded that the manner in which public pensions are provided does not fall within the political or governmental powers of the debtor.

## Stockton’s Possible Ramifications

From the vantage point of public pensions, where do we go after *Stockton*? The trajectory of that path remains highly uncertain, as the Franklin parties filed a notice of appeal as to the bankruptcy court’s confirmation of the city’s adjustment plan. Whether this appeal will finally shed some light on the ability of municipalities to impair obligations to public pensions remains to be seen. What is certain at present, however, is that two bankruptcy courts in two prominent municipal bankruptcy cases (*Detroit* and *Stockton*) concluded that public pensions are not sacrosanct, notwithstanding a great weight of state law authority to the contrary. At the same time, however, these cases illustrate the point that the ability of debtors to exercise a right as part of insolvency proceedings does not inexorably give rise to the actual exercise of that right. As with many issues in restructurings, economic considerations remain paramount in predicting the ultimate result. **abi**

**Editor’s Note:** For more on municipal bankruptcies, see *Municipalities in Peril: The ABI Guide to Chapter 9, Second Edition (ABI, 2012)*, available for purchase at [www.abi.org/bookstore](http://www.abi.org/bookstore) (members must log in first to obtain the member price). For more on the *Detroit* case, visit [www.abi.org/newsroom](http://www.abi.org/newsroom).

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<sup>21</sup> Cal. Gov. Code § 20574.