DUANE B. BEESON
NEIL BODINE
ROBERT BONSALL
GEOFFREY PILLER
CATHERINE E. AROSTEGUI
JOHN C. PROVOST
ANDREW H. BAKER
SHEILA K. SEXTON
MATTHEW MORBELLO
DALE L. BRODSKY
TEAGUE P. PATERSON
COSTA KERESTENZIS
DAVID WEINTRAUB
MARGARET A. GEDDES
PETER M. MCENTEE
SUSAN K. GAREA
VISHTASP SOROUSHIAN
CHRISTOPHER HAMMER
DALISAI NISPEROS
KATE HEGÉ

BEESON, TAYER & BODINE
ATTORNEYS AT LAW
A PROFESSIONAL CORPORATION
ROSS HOUSE, SUITE 200
483 NINTH STREET
OAKLAND, CALIFORNIA 94607-4051
(510) 625-9700
FAX (510) 625-8275

SACRAMENTO OFFICE
520 CAPITOL MALL
SUITE 300
SACRAMENTO, CA 95814-4714
(916) 325-2100
FAX (916) 325-2120

DONALD S. TAYER
(1932-2001)

WWW.BEESONTAYER.COM

tpaterson@beesontayer.com

MEMORANDUM

From: Teague P. Paterson
Date: October 17, 2014
Re: ***Stockton Bankruptcy and Pension Benefits***

On October 1, U.S. Bankruptcy Judge Christopher Klein indicated that the City of Stockton could reduce its payments to the state public pension fund CalPERs, and that the City's proposed plan of adjustment to resolve its bankruptcy, which does not provide for pension reductions, would be scrutinized with that opinion in mind. The media has described Judge Klein's decision as a significant development and a blow to pension security. For example, the New York Times broadly declared that the judge "further chip[ped] away at the idea that pensions are sacrosanct in a municipal bankruptcy." Judge Klein will likely provide his final consideration for Stockton's Chapter 9 filing on October 30.

We have looked at the legal and practical implications of this decision, and have come to three important conclusions:

- Contrary to the conclusions reached by media publications, Stockton's Chapter 9 filing will not encourage other cities to use bankruptcy to jettison their pension debt which, for most municipalities across the nation, is not dischargeable in bankruptcy.

- More likely, the ruling will dissuade municipalities from seeking bankruptcy protection under Chapter 9, as the Stockton experience indicates bankruptcy is not a practical or desirable option for cities struggling with pension debt.

- The Stockton ruling has no broad legal import – it cannot establish a binding or persuasive precedent to be used in other similar cases.

Unique Circumstances Prevent Drawing Any Broad Conclusions From Stockton

Despite the media attention focused on the Stockton and Detroit bankruptcies, there are few practical lessons to be drawn from these experiences in regard to public pensions.

To begin with, municipalities may only utilize Chapter 9 if the state has authorized it. Only roughly half the states authorize Chapter 9 filings. Of those that do, most require municipalities first to go through a process of good faith negotiations to reach consensual agreement to avoid a

Chapter 9 petition.[1] Only municipalities that are truly insolvent on a cash-flow basis can avail themselves of Chapter 9, and that level of insolvency is extremely rare.[2] According to one analysis, 13 local governments have filed for bankruptcy since 2008. Five of those filings have been dismissed. To put it in context, there are more than 20,000 local governments located in states that permit cities and counties to file for Chapter 9 bankruptcy protection.

Further, pension obligations accrue gradually and their role in municipal bankruptcies has been exaggerated. Detroit's bankruptcy was caused by a number of factors, including de-population and a sharp decrease in tax revenue, coupled with Wall Street deals that drove up city debt. Problems in Stockton were spurred by poor planning, leveraged over-development, and the housing market collapse.

In addition, a state cannot file for Chapter 9 protection, and many municipal employees are members of state pension plans by operation of statute. In states where local pensions are provided by operation of state statute under a state pension system, there is no ability to impair those pensions under Chapter 9. For example, the City of Detroit runs its own pension plan for city employees, and does not entail any state obligations or sovereignty. As a result, Detroit pensions were determined to be susceptible to impairment.

On the other hand, the State of New York's pension system is enabled by state statute and is run by the state controller. Its municipalities' employees participate by virtue of state law, and so a Chapter 9 proceeding could not impair those obligations. In California, municipalities that participate in CalPERS do so by "opting in" to the state pension system and laws. Judge Klein has indicated he considers this "opt-in" to be a form of contract that can be discharged in bankruptcy, a view vigorously contested by CalPERS, retirees and other parties.

Even narrower still, only contractual obligations may be adjusted under bankruptcy law. Many states define their public pensions as "property interests." The ruling would have no application in those states, as property rights may not be affected in bankruptcy. The unique circumstances presented by Stockton do not provide any grounds in the majority of jurisdictions.

However unjustly, bankruptcy judges have assumed that public pensions are unsecured general obligations. While institutional and sophisticated investors have obtained collateral and/or specified tax revenues to secure their investments, public employees have no such security, at least in the view of two bankruptcy judges.

California state law clearly guarantees that CalPERS-provided pensions may not be impaired through Chapter 9. Judge Klein opined that this protection is "preempted" by the Bankruptcy Code, but at the same time, under the Bankruptcy Code's rules, state laws securing general obligations in favor of Wall Street interests are not preempted. This double standard makes the Stockton opinion even more nonsensical.

[1] California adopted such a law, AB-506, in 2011, and Stockton went through this process during which significant concessions that reduced pay and pensions, were agreed to by City employees.
[2] In the seventy-plus years since California authorized municipal bankruptcies, only five or so of its thousands of instrumentalities have done so.

In light of Stockton, Municipalities Will be More Cautious of Chapter 9

Bankruptcy is not a solution to municipal financial problems. It comes with countless painful decisions that no elected official would want to make unless absolutely necessary. Chapter 9 cannot be utilized to simply jettison one category of unwanted debt, like pensions. The practicalities of running a city are better left to elected representatives who must put the needs of the citizens foremost. Bankruptcy judges have no such obligation.

Contrary to the narrative spun by Franklin Templeton, Stockton's only hold-out unsecured creditor, public workers took significant concessions throughout the bankruptcy process. The City negotiated with its employees' representatives, and workers were forced to take wage cuts and lost their retiree health package. These pay and benefit cuts dwarf, by hundreds of millions of dollars, the amount of debt held by Franklin Templeton.

Stockton does not provide endorsement of the bankruptcy process, but more a cautionary tale: A city gives up self-governance over essential policy decisions and important public priorities, and gives authority to an unelected administrator with no expertise in these complex matters of governance nor stake in their outcome. As Stockton's experience indicates, the process permits a single creditor to hold the process of bankruptcy hostage and extract the best deal it can, disregarding the needs of citizens who expect their elected leaders to provide for public safety and essential services.

The City of Stockton, unlike Detroit, has been run throughout this process by a democratically-elected city council. The City is obliged to put its citizen's interests foremost, and has pursued a plan of adjustment that does not seek a reduction in pensions. There is a very good reason for this: the retention and recruitment of necessary personnel, including police and firefighters.

Following significant employee concessions, the City wished to protect public pensions to retain and recruit police officers, firefighters, engineers and utility operators, and scores of other essential city workers. Any further reductions to pensions will cause an exodus of workers out of Stockton. Safety personnel are in demand across California and are being actively recruited by cities and counties who are facing a shortage. Additionally, California's 2013 pension law creates a new, lesser level of pension benefits for public employees hired on or after January 1, 2013. Any City employees hired prior to 2013 have "grandfathered" status under the new law, meaning they are entitled to the previous, better benefits, offered under the old law, even if they transfer to a new public agency. If Stockton's pension obligations are reduced, these workers will lose their grandfathered status if they stay with Stockton, but can preserve it if they transfer elsewhere.

We can see this play out in the examples of San Jose and San Diego. Both cities reduced pensions in 2012, then saw an exodus of safety personnel. The cities were unable to recruit new personnel because the reduced pension benefits were not competitive with what was offered by other public employers. In both cities, reduced police forces resulted in spikes in crime.

Stockton has already experienced spiked crime and deteriorating living conditions, and like all cities in California, is dependent on property tax income for revenue. Its ability to function as a city requires retaining city workers and maintaining a habitable environment. City officials

recognize this, and made a reasoned political and practical decision not to diminish employee benefits any further. Under Chapter 9, this should be respected despite the bankruptcy court's hostility to California pension laws that protect benefits from impairment.

The Stockton Case Creates Neither Binding Nor Persuasive Precedent

First, let us consider the role of the judge in this case. A bankruptcy judge is not an officer of the judicial branch under Article III of the federal Constitution, and is therefore unable to issue final precedential decisions. Article III declares the judicial branch to be a co-equal branch of the federal government, and requires judges to be appointed by the President to life terms with congressional approval in order to exercise the "the judicial power of the United States." Because bankruptcy judges are not appointed in accordance with Article III, they are not members of the judicial branch empowered to exercise such authority.[3] This means that a bankruptcy judge's decisions are only applicable to the parties involved in core bankruptcy proceedings – in this case, the City of Stockton and its creditors.

Next, Stockton's plan of adjustment prevents the court from creating precedent. Under section 904 of Chapter 9, a bankruptcy judge may not "interfere with any of the political or governmental powers of the debtor…" unless the city "consents or the plan so provides." In practical terms, this means that a bankruptcy judge cannot override the power of the city [the "debtor"] to determine how to deal with pension obligations in its plan of adjustment.

As explained above, the City of Stockton – for good reason – does not seek to reduce pension benefits in its plan of adjustment. The provision of pensions to public employees is considered by federal and California law as an "essential governmental function."[4] Stockton's decision regarding pensions, therefore, is beyond the authority of the bankruptcy court under section 904. The bankruptcy court has no authority to determine that Stockton *should* impair employees' pensions, and the City has not asked the court whether it *could* impair pensions. Therefore the court's opinion on that point is an improper advisory opinion, the legal equivalent of an editorial comment. [5]

Lastly, a bankruptcy court's authority under Chapter 9 is very limited. When presented with a proposed plan of adjustment, the court can either approve the plan if certain criteria are met, or reject the plan and dismiss the bankruptcy petition. Once presented with a plan, a bankruptcy court cannot issue substantive findings, make rulings of law, or opine as to how a city should adjust its obligations.

---

[3] *Stern v. Marshall* (2011) 131 S.Ct. 2494.

[4] *San Diego County Employees Retirement Assn. v. Superior Court* (2011) 196 Cal.App.4th 1228, 1237 (noting "the governmental function of calculating and paying out monthly pension benefits."); *Bellus v. City of Eureka* (1968) 69 Cal.2d 336, 345 ("establishment of an employee pension plan is a municipal affair."); I.R.S. P.L.R. 200946028 (Nov. 13, 2009)("Providing post-employment benefits "constitutes the performance of an essential governmental function within the meaning" of section 115 of the IRC.); I.R.S. P.L.R. 8825087 (June 24, 1988)("The provision for retirement benefits for municipal employees is a generally accepted function of state and local government… is a recognized governmental function that directly benefits the City.")

[5] Judicial decisions that do not resolve actual "cases and controversies" as required under Article III of the U.S. Constitution are considered "improper advisory opinions." *Princeton University v. Schmid* (1982) 455 U.S. 100, 102 ("We do not sit to decide hypothetical issues…").

Stockton's plan of adjustment may be approved on October 30. If the judge rejects the plan, the City or other creditors may seek to dismiss the bankruptcy. Alternatively, Stockton may re-negotiate and submit another plan that, similarly, does not provide for impairment of pensions. Under each of these scenarios the bankruptcy court's views on the impairment of pensions are simply editorial.

Only if the City ultimately submitted a plan that provided for impairment of pensions would the bankruptcy court's ruling on the subject have significance. The City is unlikely to take this course of action, since, on October 3, the City of Stockton informed the court that it cannot function as a city if pensions are impaired. If a plan were submitted to reduce pension benefits, an appeal would likely follow, and the City's resolution of its bankruptcy further delayed.