

Pensions After Detroit: Ramifications and Other Reforms

Can Unaffordable Pension Benefits Be
Rolled Back, Reduced or Changed?

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© 2014 by James E. Spiotto. All rights reserved. This presentation discusses the current state of the Chapter 9 market including a detailed analysis on these issues and bondholder rights and remedies. For further reading: Remarks of James E. Spiotto of Chapman and Cutler LLP to the U.S. Securities and Exchange Commission field hearing at Birmingham, Alabama on July 29, 2011 on the State of the Municipal Securities Market, Remarks of James E. Spiotto of Chapman and Cutler LLP, and a book entitled *MUNICIPALITIES IN DISTRESS?* published by Chapman and Cutler LLP which is a 50-State Survey of State Laws Dealing with Financial Emergencies of Local Governments, Rights and Remedies Provided by States to Investors in Financially Distressed Local Government Debt, and State Authorization of Municipalities to File Chapter 9 Bankruptcy, which is available from Chapman and Cutler LLP or on Amazon.com, *PRIMER ON MUNICIPAL DEBT ADJUSTMENT*, published by Chapman and Cutler LLP, which is available from Chapman and Cutler LLP, "The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress," by James E. Spiotto in the *MUNICIPAL FINANCE JOURNAL*, Winter/Spring 2013 and "All Eyes on Detroit: What Happens to Unfunded Pension Liabilities When a Municipality Files for Bankruptcy?" *MUNINET GUIDE* (August 21, 2013), <http://www.muninetguide.com/print/php?id=604>.

Can Unaffordable Pension Benefits Be Rolled Back, Reduced or Changed?

- A. The transition of pensions from a gratuity (to be paid if you want) to a contractual obligation (that is enforceable):
- Different Approaches. States take different approaches in analyzing the pension rights of public employees and whether those rights can be modified.
 - Pensions as Gratuities. Prior to the second half of the 1900's, pension payments were considered to be in the nature of a gratuity that could be reduced at will. Pension obligations were viewed as "pay as you go" since they were to be paid if there were funds and if the state or local government so desired.
 - Current Treatment of Pensions. Currently, states take different approaches in dealing with the impairment of pension benefits.

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CATEGORIZATION OF CERTAIN STATE PUBLIC EMPLOYEE PENSION PROVISIONS

Specific State Constitution Prohibiting Impairment of Public Employee Pensions	General Constitutional Prohibition Against Impairment of Contracts (Applicability to Pensions Depends on Whether the Courts View Pensions as Contractual Obligations; Also, States that Do Not Have Their Own Contract Clause Oftentimes Rely on the Contract Clause of the U.S. Constitution):	State Statute or Case Law Prohibiting Impairment of Public Employee Pensions
Alaska, Arizona, Hawaii, Illinois, Michigan, New Hampshire, New York, Texas	Arkansas, Georgia, Indiana, Nebraska, New Jersey, Oklahoma, Rhode Island, Tennessee, West Virginia	Alabama, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, South Dakota, Utah, Vermont, Virginia, Washington, Wisconsin, Wyoming

B. The Development of the constitutional, statutory and case law provisions on pension obligations being a contractual obligation that could be enforced in most cases:

- Contractual Rights. Generally, state constitutional or statutory provisions provide that pension benefits are contractual rights.
- Impairment. A non-impairment law is not intended to stretch pensions beyond their elastic limits.

- Developed Case Law that Permitted Modification of Pensions. As circumstances change and available funds are stressed pensions can be and need to be changed, but within certain parameters:
 - Right to modify must be clear in legislation, employment agreements and union contract (Rhode Island).
 - Adverse conditions which could lead to the failure of pension plan and the purpose of the legislation justifies amendment (Vermont).
 - To balance adverse consequence of actuarially necessary changes to strengthen or improve the pension plan (Colorado, West Virginia).
 - Reasonable modifications that bear material relationship to theory of pension system and successful operation (Massachusetts).

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- Certain legislation by its nature cannot bind successive legislatures and can be changed (Georgia).
- Contractual pension rights may be altered if changes are related to maintaining a healthy pension system as a whole. Changes that disadvantage members must be accompanied by comparable new advantages (California).
- Caps on cost of living increases or changes in percentages used for increases that cut the benefits were upheld in order to maintain the viability of the pension program (Minnesota, South Dakota, New Jersey and Colorado).

- What Can Be Adjusted. The non-impairment laws are not all-encompassing and have been held not to reach:
 - Benefits that accrue in the future.
 - Reduction in mandatory retirement age.
 - Reduction in hours or salary.
 - Loss of benefits for non-compliance with the plan.
 - Dismissal of public employee.
 - Even though such may indirectly affect the pension benefits received.

- The Argument for Pension Adjustments in Time of Insolvency. Pension obligations can, in very extreme circumstances, be “discharged” where necessary to serve an important public purpose:
 - If the state and local government cannot fund pension obligations and essential government services since there are not sufficient tax revenues to pay for essential government services and pay pension obligations then pension obligation must be adjusted for the common good.
 - This is an inability (insolvency) not an unwillingness to pay.
 - Pension obligations cannot be enforced if to do so would frustrate the essential purpose of the governmental body and sacrifice the required services it must provide.

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- The U.S. Supreme Court has supported the ability of the state to set up municipal receiverships or other quasi-judicial mechanism to discharge obligations that cannot be paid given the dire financial condition and the need to continue governmental services for the financial survival of the governmental body.
- Bridgeport, Connecticut, in the 1990s had reduced revenues and in order to balance its budget, as required by state law, it reduced services and increased taxes only to find individual and corporate taxpayers left and revenues were further reduced (*The Death Spiral*).

- U.S. Supreme Court has recognized the need for contractual impairment to protect health, safety and welfare of local citizens. In the case of *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942), the New Jersey Municipal Finance Act provided that a state agency could place a bankrupt local government into receivership. Under the law, similar to a Plan of Adjustment for a Chapter 9 municipal bankruptcy action, the interested parties could devise a plan that would be binding on nonconsenting creditors if a state court decided that the municipality could not otherwise pay its creditors and the plan was in the best interest of all creditors. *Id.* at 504. After certain bondholders dissented, the court determined that the plan helped the city meet its obligations more effectively. *Id.* **“The necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city’s debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired.”** *Id.* at 511. The court then found that the plan protected creditors and was not in violation of the Contract Clause. *Id.* at 513. *See also U.S. Trust v. New Jersey*, 431 U.S. 1, 25-28 (1997).

- This precedent has been used to justify pension reform. Recently, the Supreme Court of Puerto Rico has ruled (*citing* the *U.S. Trust v. New Jersey* case) that the protection of pension obligations is not absolute but may be modified if reasonable and necessary to advance an important public interest, namely a financial crisis that threatens the actuarial solvency of the pension system. *Hernandez v. Commonwealth*, 2013 WL 3586616. (S. Ct. Puerto Rico, June 24, 2013).

C. Municipal insolvency and Chapter 9 impairment of pension obligations:

- Involuntary Modifications of Public Pensions Outside of Chapter 9 Bankruptcy is Difficult. Outside of a Bankruptcy Court Order, changes of pension obligations (unilateral reductions) are practically and politically unlikely but may provide the best results:
 - Most State Court Judges are elected by those affected, either directly or indirectly.
 - This is a local rather than federal matter.
 - Most pension plans are subject to State Constitutional or statutory provisions that may not permit the change.
 - Pension benefit reduction is obviously unpopular and causes “morale” issues.

- If the state or local government fails financially, the pension system is sure to follow. But “Necessity knows no laws.” Change may be mandated by the reality of the situation – if the state or local government fails financially then it has less funds to keep public employees hired and to pay for pensions. Thus, the pension system will fail, pensioners will receive less, the purpose of the pension will be frustrated and less is truly more, especially if less is assured. Timely modification may save the state or local government and the pension system.
- Pension adjustment mandated by financial distress. There is precedent to “discharge” pension obligations where the governmental body’s survival mandates such action so that essential government services can continue to be provided. *See Faitoute Iron & Steel Co. v. City of Ashbury Park*, 316 U.S. 511-513 and *U.S Trust v. New Jersey*, 431 U.S. 1, 25-28.

- Survival of the State or Local Government is Key to Long-Term Survival of Pensions. The inability of a state or municipality to fund essential governmental services at an acceptable level can be fatal to its survival à la Detroit:
 - Pay what is sustainable and affordable. What is needed is a mechanism that provides an independent and neutral determination of what is affordable and sustainable so the debate of unwillingness or inability can be transcended to what can be paid and what cannot with appropriate mandated increased funding or adjustment to what can be afforded as pension benefits without eroding infrastructure and essential governmental services at an acceptable level.
 - Bankruptcy may lead to more drastic reductions. Bankruptcy is not only rare but is accompanied by a stigma that affects all creditor relations of the government and has far reaching negative consequences. Intermediate step that provides the benefits of a neutral, independent determination of fact issues and a mechanism for funding the affordable benefit is not only desired but necessary. Otherwise, the ultimate harsh result will be far worse to all.

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- Not every municipality can file for Chapter 9. Chapter 9 Municipal Debt Adjustment is available in some states as a means to a municipality to adjust its pension obligations. If the state does not authorize its municipalities to file Chapter 9 then municipal bankruptcy is not available.
- Difference between Chapter 9 and Chapter 11. Unlike a Corporate Chapter 11 proceeding only a municipality (if authorized by its State) can file for Chapter 9 (creditors have no right to initiate a Chapter 9). There is a low threshold for rejecting of labor contracts in a Chapter 9 (“unduly burdensome in proposing a plan”) (unlike Section 1113 of the Bankruptcy Code for Corporations-multi-step procedure of disclosure, a proposal and negotiations first). There are no priorities for unpaid wages, benefits or accrued vacation or retirement benefits (Chapter 11 provides a priority over unsecured creditors of up to \$12,475 per employee for prepetition wages, benefits accrued vacations and healthcare benefits).

- Who Can Be a Chapter 9 Debtor? Not every municipality can be a debtor in Chapter 9. Only municipalities in states that specifically authorize their municipalities to file can use Chapter 9. States as co-sovereigns of the federal government cannot use Chapter 9 or any federal bankruptcy forum. To be a debtor in a Chapter 9, an entity must be:
 - An entity that is a municipality.

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- Specifically authorized under State law to be a Debtor. Twelve States have Statutory Provisions in which the State specifically authorizes filing (AL, AZ, AR, ID, MN, MO, MT, NE, OK, SC, TX, WA), another twelve States authorize a filing conditioned on a further act of the State, an Elected Official or State entity (CA, CT, FL, KY, LA, MI, NJ, NC, NY, OH, PA, RI) Three states (CO, OR and IL) grant limited authorization, two states prohibit filing (GA) but one of them (IA) has an exception to the prohibition. The remaining 21 are either unclear or do not have specific authorization.
- Insolvent (unable to pay its debt as they mature).

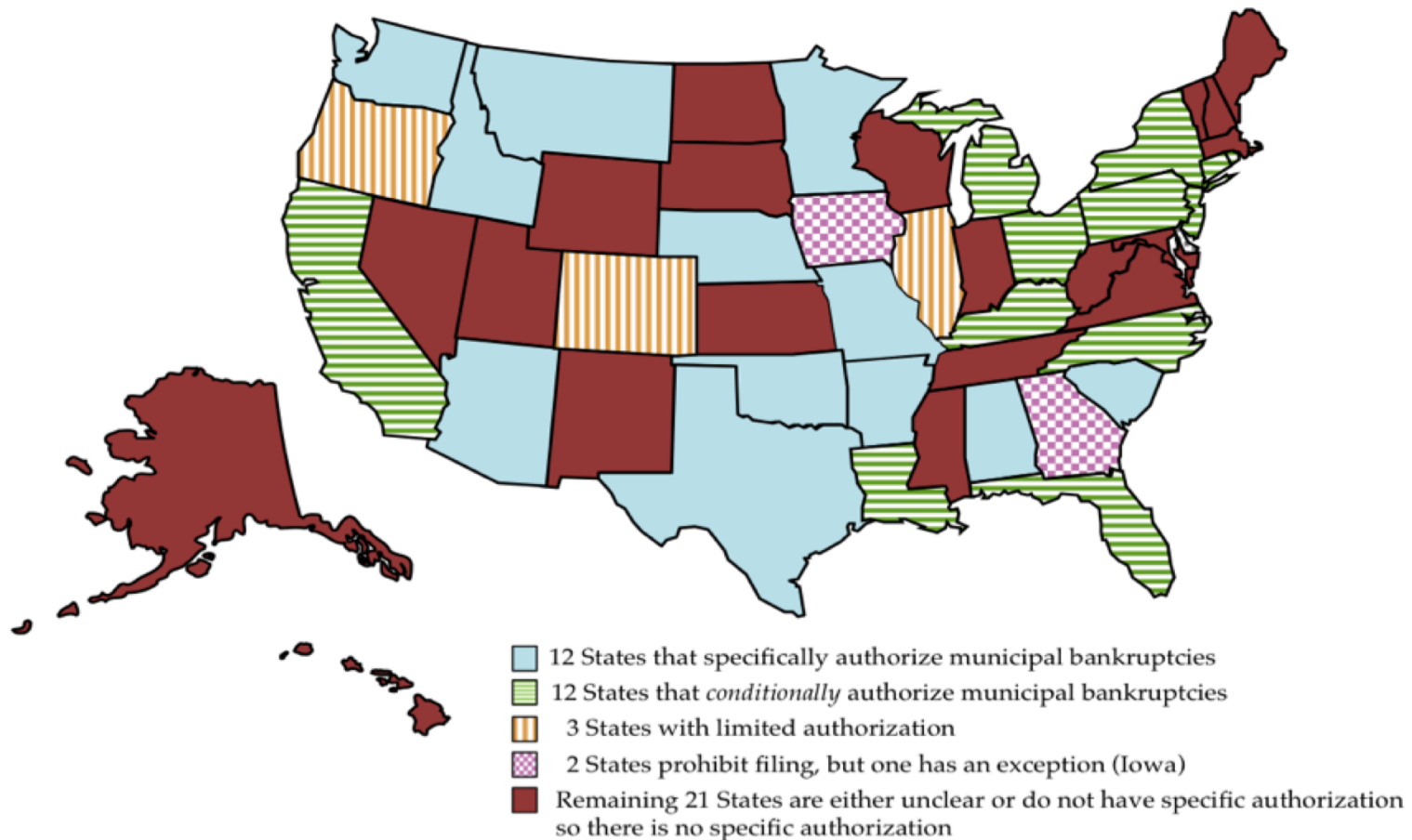
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- Willing to effectuate a plan.
- Either have obtained the agreement of creditors holding majority amount of the claim of each class that the municipality intends to impair or have attempted to negotiate in good faith, but was unable to do so or it was impractical to negotiate with creditors or a creditor is attempting to obtain a preference.

The States that Authorize Chapter 9



The State Statutes Regarding Chapter 9

The following are statutory provisions in which states have authorized Chapter 9 filings for certain governmental entities.

12 States that specifically authorize municipal bankruptcies:

Ala. Code 1975 § 11-81-3 (For Bonds Not Warrants)
Ariz. Rev. Stat. Ann. § 35-603
Ark. Code Ann. § 14-74-103
Idaho Code Ann. § 67-3903
Minn. Stat. Ann. § 471.831
Mo. Ann. Stat. § 427.100
Mont. Code Ann. § 7-7-132
Neb. Rev. St. § 13-402
Okla. Stat. Ann. tit. 62 §§ 281, 283
S.C. Code Ann. § 6-1-10
Tex. Loc. Gov't Code § 140.001
Wash. Rev. Code § 39.64.040

The 21 Remaining States are either unclear or do not have specific authorization. AK, DE, HI, IN, KS, ME, MD, MA, MS, NE, NH, NM, ND, SD, TN, UT, VA, VT, WV, WI, WY.

12 States that conditionally authorize municipal bankruptcies:

Cal. Gov't Code § 53760
Conn. Gen. Stat. Ann. § 7-566
Fla. Stat. Ann. § 218.01 and §218.503
Ky. Rev. Stat Ann. § 66.400
La. Rev. Stat. Ann. § 39-619
Mich. Comp. Laws § 141.1222
N.J. Stat. Ann. § 52:27-40
N.C. Gen. Stat. Ann. § 23-48
N.Y. Local Finance Law § 85.80
Ohio Rev. Code Ann. § 133.36
53 Pa. Cons. Stat. Ann. § 11701.261
R.I. Gen. Laws §45-9-7

3 States with limited authorization

- Colorado has enacted legislation specifically authorizing its beleaguered special taxing districts to file a petition under Chapter 9. Section 32-1-1403 of the Colorado revised statutes states that "any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law and to take any and all action necessary or proper to carry out the plan filed with said petition..." (CRS § 37-32-102 (Drainage & Irrigation District))
- Oregon permits Irrigation and Drainage Districts to file (Or. Rev. Stat. § 548.705)
- Illinois – specific authorization solely for the Illinois Power Agency (20 Ill Comp. Stat. Ann. 385/1-20(b)(15)). The Local Government Financing and Supervision Act permits that commission to recommend that the Legislature authorize a filing but it is not specific authorization (20 Ill. Comp. Stat. Ann. 320/9(b)(4))

2 States prohibit filing but one has an Exception

- Iowa generally prohibits filing Chapter 9 (Ia. Code Ann. § 76.16) but allows filing for insolvency caused by debt involuntarily incurred not covered by insurance proceeds (Ia. Code Ann. § 76.16A)
- Georgia prohibits the filing of Chapter 9 Bankruptcy (Ga. Code Ann. § 36-80-5)

D. Current use of Chapter 9:

- No Tsunami of Chapter 9 filings in 2011, 2012 and 2013:
 - Only 13 Chapter 9 filings in 2011, 12 Chapter 9 filings in 2012, 8 Chapter 9 filings in 2013.
 - Cities, towns, counties or villages in 2012, namely Jefferson County, Boise County, Idaho (dismissed that year), Harrisburg, Pennsylvania (dismissed), and Central Falls, Rhode Island, in 2011, Stockton, San Bernardino and Mammoth Lakes (which was dismissed that year) in 2012 and Detroit in 2013.
 - Total Chapter 9 filings since 1937 – 651.
 - Since 1954, there have been 307 Chapter 9 filings and only 63 of those involved cities, towns, villages and counties and of those, 29 never had a plan of debt adjustment confirmed.
 - Still RARE and mainly small special tax districts, municipal utilities.

- If Municipalities Cannot Use Chapter 9, What Can Be Done?
Absent the use of recourse to Chapter 9 the ability of state courts to address underfunding is uncertain and probably unsatisfactory. Pension plans and provisions for employee benefits should be written to permit modification, especially in the case of dire necessity or hardship to the governmental body. Absent that provision permitting modification, there may be difficulty in obtaining Court relief except for impairment permitted for a higher public purpose. Further, state constitutional provisions may prohibit any reduction to the extent of earned benefits:

E. Recent Chapter 9 court decision on ability of municipality to modify pension obligation:

Vallejo

- Exited Chapter 9 without tackling pension costs. The city's annual contribution to CalPERs more than \$14 million in 2013.

Stockton

- Proposed plan leaves pensions untouched and proposes to continue making required payments to CalPERs.

Previously, bankruptcy court judge had suggested Stockton would have difficulty confirming a plan without confronting pension obligations and suggested in dicta that pensions were contractual obligations that could be impaired in a Chapter 9.

- San Bernardino – In holding that San Bernardino was eligible to be a debtor under Chapter 9 and rejecting the objection of CalPERs to the filing, the court noted: “The city cannot pay its obligations with money it does not have.... Impairment of Contracts seems inevitable....” *In re City of San Bernardino California*, 49 BR 776 (Bankr. C.D. Ca. 2013) (Decision on appeal).

Detroit

- In rejecting a constitutional challenge to Chapter 9, the court held that pension benefits can be adjusted in Chapter 9 like any other debt obligation regardless of any state constitutional provisions. Further, while pension benefits can be cut, the plan must be fair and equitable. *In re City of Detroit*, 2013 WL 6834647 (Bankr. E.D. Mich.). (Decision on appeal).

F. But what do state and local governments do if they cannot file Chapter 9?

- Use of U.S. Supreme Court precedent in U.S. Trust and Asbury Park cases to permit adjustment of pension obligations for a higher public purpose – the survival of the government.

Puerto Rico

- Puerto Rican Supreme Court not a Chapter 9 case. This court upheld legislation reforming the Commonwealth's pension system in a challenge based on a constitutional provision that no laws impairing the obligations of contract shall be enacted. The court held the reforms were necessary to deal with the financial crisis that threatened the actuarial solvency of the system and that contractual protections were not absolute but must be harmonized with the public interest.

San Jose

- In another non-bankruptcy case, the state court in *San Jose Public Officers' Association v. City of San Jose*, No. 1-12-CV-225926 (Superior Ct. of Ca., Santa Clara County December 20, 2013), took an approach different from the Puerto Rican Supreme Court. Specifically, the court found **invalid** provisions due to fiscal and service emergency such as:
 - Provided for increased pensions contributions for current employees to cover unfunded actuarially accrued liabilities.
 - An alternative retirement plan for employees who wish to avoid increased contribution rates.

San Jose cont'd

- Suspension of all or part of COLA payments due to all retirees.

However, the court rejected a number of other claims, and found the reform of pensions was valid as to, *inter alia*, objections based upon equitable and promissory estoppel and a change in the definition of “disabled worker” to not able to work at all.

- All these provisions had been approved in a referendum by about 70% of the voters.

San Jose cont'd

- While referring to a budget and economic crises that had precipitated the enactment of the modifications, the court focused on the violation of vested rights and did not discuss the impact the ruling would have on the ever-increasing unfunded pension liability or higher public purpose.
- The court did not hold that the vested rights doctrine did not mean that pension provisions could never be changed.
- According to the court, the modification of pensions must not frustrate the reasonable expectations of the parties to the contract of employment.

- G. Outside Chapter 9 what involuntary modification can be made in financial distress situation?
1. To Rescue Failing Plans. If the pension plan is to fail or is actuarially unsound, Courts have allowed change to provide a better outcome than uncontrolled collapse.
 2. To Change Unworkable Legislation. Pension plan base upon legislation (State or local) which does not work can and should be changed and courts have recognized the need and ability for such a change.
 3. To Balance Rights and Interests. Some Courts have attempted to balance the interest and benefits in authorizing change to pension plans.

4. These Principles in Practice:

- Changes to prevent pension plan from failing. Even states that find that their relevant contracts clauses prevent an impairment of pension rights, typically hold that adverse conditions which could lead to the failure of the pension plan and thus the purpose of the legislation itself, justify amendments to the plan.
- Balancing advantages versus disadvantages of proposed modifications. Accordingly, in Colorado, a pension plan can be changed so long as any adverse modification is balanced by a corresponding change of a beneficial nature, a change that is actuarially necessary, or a change that strengthens or improves the pension plan. *McInerney v. Public Employees' Ret. Ass'n*, 976 P.2d 348, 352 (Colo. App. 1999).

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- Reasonable modification of pension in furtherance of the theory of the pension system. In Massachusetts, modifications to a state retirement scheme can be permitted so long as such modifications are reasonable and bear some material relationship to the theory of a pension system and its successful operation. *Madden v. Contributory Retirement Appeal Board*, 729 N.E.2d 1095 (Mass. 2000).
- Modification of pension must be related to higher public purpose. The courts of Vermont have found that, even if a party's contract rights have been impaired, the contract clause is only violated where the impairment is not reasonable and necessary to achieve an important public purpose. Accordingly, an ordinance requiring greater contributions by employees along with increased benefits was not an impermissible impairment. *Burlington Fire Fighters' Ass'n v. City of Burlington*, 543 A.2d 686 (Vt. 1988).

- Does significant impairment reasonably relate to a justifiable public good. West Virginia has also adopted a balancing test holding that, where a substantial impairment has been shown and a legitimate public purpose for the impairment is demonstrated, a court must determine whether the adjustment of the rights and responsibilities of the contracting parties is based upon reasonable conditions and is of a character appropriate to the public purpose justifying the legislation adopted. *State ex rel. West Virginia Regional Jail & Correctional Facility Auth. v. West Virginia Inv. Mgmt. Bd.*, 508 S.E.2d 130 (W.Va. 1998).

Conclusion

- Pensions started as gratuities and as public workers demanded more assurance of pensions being funded constitutional and statutory provisions were adopted to provide enforceability of pension obligations.
- Pension obligations that crowd out essential government services and infrastructure necessary for the long-term survival of the state or local government should be adjusted to that which is sustainable and affordable without the adverse affect on governmental services.

- In Chapter 9 public pensions are subject to modification to the degree necessary for the municipality to provide essential governmental services at an acceptable level for the survival of the municipality and the pension system based on recent decisions in Detroit, San Bernardino and others.
- If Chapter 9 is not available or not desirable then pension obligations should likewise be modified in the least drastic manner for the survival of the state or local government but that may not be easily done.