Stockton Pension Ruling Bolsters Case For CalPERS Reform

By **Andrew Scurria**

Law360, New York (October 02, 2014, 9:04 PM ET) -- Now that a federal judge has eliminated the sanctity of California cities' pension obligations in bankruptcy, experts say the political moment is ripe to forge a path for distressed municipalities to roll back those crushing debts outside of Chapter 9.

The **decision** carries huge implications for cities, retirees and capital markets, and attorneys expect it to reignite debate over how municipalities struggling under payments to the powerful California Public Employees' Retirement System can adjust pension costs without sparking an exodus among their workers.

While the ruling isn't binding on other courts, it touches on the most pressing issue facing struggling cities today. U.S. Bankruptcy Judge Christopher Klein held that Stockton has the power under core bankruptcy principles to shred its contract with CalPERS, putting pensions on the table for the first time in restructuring scenarios.

California municipalities won't rush to file for Chapter 9 protection, but experts say the decision has underscored the need for a nonbankruptcy solution to spiraling pension bills. At stake is the worker retention model at the heart of urban policy, which promises a comfortable retirement to make up for lower lifetime salaries.

"While this case with the city of Stockton, being a small town, may be like shooting the archduke of Sarajevo in 1914, it could start its own version of World War I," said Harvey Leiderman of Reed Smith LLP.

In the short term, Judge Klein has given municipal bondholders a leg up in negotiations with unions and retiree groups by raising the possibility that cities could enter bankruptcy and adjust their debts to CalPERS, one of the largest institutional investors in the country.

If retirees can indeed absorb losses, as Judge Klein has held, it will benefit bondholders and their insurers, which typically bear the brunt of the pain in Chapter 9 proceedings. California cities pay into the system and can't terminate that relationship without assuming responsibility for their retirees' vested benefits.

Stockton elected in its restructuring plan to stay part of CalPERS, meaning it had to satisfy 100 percent of its obligations to the system. The city's lone holdout creditor, Franklin Templeton Investments Inc., has argued that its 1 percent recovery under the plan was a slap in the face, when pensions were paid in full.

The judge’s decision held that California law preventing Chapter 9 debtors from pulling out of CalPERS was “flat-out invalid” in light of the U.S. Bankruptcy Code, which lets cities and corporations shred burdensome contracts. That holding, according to Craig Barbarosh of Katten Muchin Rosenman LLP, changes the leverage points of the stakeholders in a distressed city and weakens pensioners’ bargaining position.

“This will potentially cause participants in other situations to see if they can work it out outside of a bankruptcy filing,” Barbarosh said. “There will be a greater willingness by pension representatives to negotiate and modify those [debts] rather than risking what could happen in litigation.”

While pensions have been impaired in bankruptcy before, it was always with the consent of the affected workers. Detroit’s retirees, for example, took modest benefit cuts in a series of settlements that got them behind the city’s plan of adjustment.

As part of CalPERS, Stockton didn’t have that option. The burden is now on state legislators to craft an alternative way for cities to cut pension debts without the massive liability that comes with leaving CalPERS, according to Karol Dennison of Squire Patton Boggs LLP. Under Judge Klein's ruling, the only way to cut pension debt is to file for Chapter 9.

“How crazy is that?” Denniston said. “Do we really want the only place for cities to manage their pension liability to be in bankruptcy court, or does the Legislature in California and the CalPERS member entities want to have a serious conversation about creating a workable alternative?”

Denniston says that even if the plan succeeds, CalPERS should seize the moment to bring unions, capital market creditors and taxpayers into the discussion about a new program with a restructuring option other than "pay 100 percent or else we terminate.” The political pressure will increase now that the pension issue is back in the headlines, she says.

“It’s a game changer because of the number of taxpayers living in cities in California with service insolvencies that are actively watching,” Denniston said. “These are the folks that are ultimately footing the bill, so when they begin to pay attention, this becomes a gateway and a conversation in elections.”

As cities have teetered on the brink, Washington has also taken notice. In June, Sens. Elizabeth Warren, D-Mass., and Jay Rockefeller, D-W.Va., introduced a bill limiting the ability of private-sector and municipal debtors to wipe out pensions in bankruptcy.

The legislation went nowhere, but it underscored the political concern over cutting pensions, which have long been viewed as sacrosanct, said Ted Gavin, a principal at turnaround shop Gavin/Solmonese. Unlike bondholders, workers aren’t paid a premium for the risk that a city won’t repay them.

"There is going to be a lot of pressure from all corners to resist doing anything that changes so fundamentally the notion of a pension obligation for public employees," Gavin said. "But maybe it's with Stockton that we start to move forward and understand what pensions should actually look like."

In the meantime, he says, most cities will opt to deal with fiscal problems outside of bankruptcy court, where the process is sometimes long and always expensive.

"There will be a lot of pressure for the parties to come together and strike the best deal that they can ... and not see a judge decide what's going to or isn't going to happen," Gavin said. "It probably has to be CalPERS bringing the other two parties in the triangle together and saying: Union, city, cut a deal."

Of course, Judge Klein's decision could be reversed, or an unexpected settlement with Franklin could render it moot. Leiderman said the ruling could be vulnerable on appeal because it went against years of jurisprudence on states' right to regulate their cities. The judge has not ruled on whether to confirm the plan, saying he needed to take a fresh look at its fairness and feasibility in light of his pension impairment ruling.

An Oct. 30 confirmation hearing will shed more light on whether cities can reorganize without touching pensions, with the answer weighing heavily on those that are eyeing bankruptcy as an option.

"It would be a better result not to have a lot of California cities in Chapter 9," Denniston said. "This is a very challenging environment for cities to operate in, and there's got to be a better way."

--Editing by Kat Laskowski and Chris Yates.