

Avoiding Municipal Bankruptcy Pension Cost + Financial Pressure



Agenda



- I. Introduction and Overview of “Avoiding Municipal Bankruptcy” Webinar Series (Karol K. Denniston, Jeff Chang and Isabel C. Safie)
- II. Pension Reforms and Solutions (California State Senator Moorlach and Chief of Staff Lance Christensen)
- III. CalPERS (Jeff Chang)
- IV. California Rule Update (Isabel C. Safie)
- V. Avoiding Bankruptcy (Karol K. Denniston)
- VI. Panel Discussion/Q&A
- VII. Closing

Pensions: Why we need to talk about Avoiding Bankruptcy

- Municipal Challenges
 - Service Insolvency
 - Negative cash flow
 - Limited capital improvements

Financial Stress

- Increasing contributions
- Reduced amortization
- Unreasonable termination

CaPERS

- California and National Reform Efforts
- California Rule

Judicial and Legislative Reform Efforts

Employers in the Headlines Fiscal Distress



Antioch

Barstow

**Santa
Cruz**

Martinez

Employers

- Focused on current and future cash flow
- Recognition that shortfalls are likely

Taxpayers

- Active reform groups
- Ballot initiatives
- Election of pension reform advocates

Municipal Options

- Sales tax increases
- Out of court restructuring
- Bankruptcy

PENSION REFORMS AND SOLUTIONS, BUT...

Senator John M. W. Moorlach



SB 671 - Pension prepayment (clarification & expansion – 2 yrs)



- Based on prepayment notes issued by OC to contribute to OCERS at beginning of year or six months prior, with a incentivizing discount (chaptered 7/17/17)

SB 32 - PEPRA II



- 1) Take AB 32 concept of requiring pension liabilities to be reduced to 1980 levels
- 2) Take items that fell on the cutting room floor with PEPRA and reintroduce
- 3) Killed in Senate Public Employment and Retirement Committee on April 24, 2017

SB 371 - Bargaining Conflicts of Interest



- 1) Premised on the concern that the negotiators for the agency would be conflicted if they received the same benefits that were being bargained for
- 2) Killed in Senate Public Employment and Retirement Committee on May 8, 2017

SB 454 - GASB 45 – OPEB Full Funding



- 1) Would require state to solely prefund retiree medical health care
- 2) Model is Orange County. Why increase pay to absorb retiree medical withholding?
Exacerbate the compensation earnable pension calculation?
- 3) Killed in Senate Public Employment and Retirement Committee on April 24, 2017

SB 656 - Judicial Retirement Reforms (JRS II)



- 1) Modify pension cliff vesting for Superior Court Judges with deferral adjustment
- 2) The DB/DC hybrid was forcing many to work during chemo treatments
- 3) Awaiting Governor's signature

SB 681 - CalPERS Exiting Reform



- 1) Current exit formula is cost prohibitive
- 2) Calculating the fee using a 2% investment assumption rate validates that the 7.25% rate for plan sponsors is fraudulent
- 3) Loyalton – just pay the delta to retirees
- 4) Killed in Senate Public Employment and Retirement Committee on Jan. 8, 2018

SCA 8 - Abolish the “California Rule”



- 1) If Marin Case not heard, take a legislative approach
- 2) Killed in Senate Public Employment and Retirement Committee on August 13, 2018

SCA 10 - Voter Approval of Pension Debt



- 1) Charter of City and County of San Francisco provision for over a century
- 2) Duplicated in Orange County with Measure J in 2008
- 3) Killed in Senate Public Employment and Retirement Committee on August 13, 2018

SB 1031 - Temporary COLA freeze



- 1) If the plan is 80% funded or worse, then future retirees should have cost of living adjustment increases deferred
- 2) Retirees should also be invested in protecting sustainability of the plan
- 3) Killed in Senate Public Employment and Retirement Committee on April 23, 2018

SB 1032 - Terminated Agency Pool (TAP)



- 1) Second attempt to eliminate
- 2) Loyalton exit strategy should be memorialized in state code
- 3) Killed in Senate Public Employment and Retirement Committee on April 23, 2018

SB 1033 - Pension Reciprocity



- 1) Prevent final employer from soaking previous employers because of a high ending salary
- 2) Concerns over poor calculations
- 3) CalPERS was addressing internally
- 3) Put on hold and tabled for the Session

SB 1433 - Restrict the Deferred Retirement Option Program (DROP)



- 1) This sad scheme is a method to encourage public safety employees to work beyond the age of 50
- 2) City of Los Angeles costly experience
- 3) *LA Times* investigative reports
- 4) Killed in Senate Public Employment and Retirement Committee on April 23, 2018

SB 1149 (Glazer) - DC Optional



- 1) Allow new employees to select a DC retirement plan
- 2) UC System shows a 37% participation rate
- 3) Allowed for conversion to DB
- 4) Co-Author
- 5) Killed in Senate Public Employment and Retirement Committee on April 23, 2018



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CALPER'S UPDATE

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Difficult Times at CalPERS

- CalPERS still seriously underfunded (~70%) despite 7-year bull market. Robust equities market gains offset by zero percent interest. Would be only 55% funded if private sector rates are used.
- If CalPERS were a private sector multiemployer pension plan, it would be in “critical status” and might even be considering a “reduction of benefits.”
- CalPERS is not alone among state pension systems with problems (in 2016, it ranked 25th).
- Changing market conditions are forcing all DB plans to reevaluate interest assumptions and funding requirements.

- CalPERS Board must look out for the overall health of the system, not that of a particular member agency. Taking aggressive actions to improve funded status.
- According to Cal. League of Cities/Bartel report (1/18):
 - CalPERS contributions as a % of cities' Gen. Fund \$\$ will nearly double in the next years, with 10% of cities paying more than 21.5% by 2024-25 (> 40% of payroll for misc. ; > 64% for safety).
 - Pension costs will become unsustainable for many cities
 - Financial reporting of pension/OPEB liabilities is forcing review of funding/discount assumptions

What if Agencies Can't Afford CalPERS?

Currently only four options:

- Bankruptcy
- Voluntary Contract Termination (Govt. Code 20570 et. seq.). CalPERS takes over liabilities and charges a termination fee based on “safe” long-term interest rate, which results in a termination assessment of 3 – 4 times current UAL. This charge, a deterrent.
- Involuntary Contract Termination (Govt. Code 20572). Recently, several agencies have stopped paying CalPERS. CalPERS has sought to collect. After extended collection/negotiation efforts, CalPERS “determines” to involuntarily terminate contract and reduce affected participants’ benefits to the extend funded (e.g., 60%).
 - CalPERS has flexibility to negotiate liabilities and funding in such cases. This is likely to become more frequently utilized by distressed agencies.
- Disincorporation? (Govt. Code 56000 – 57550)

Changes in the “vested rights doctrine”? Planning for the future?



- I. The Cal. Supreme Ct. could change the “vested rights doctrine” to allow public agencies to modify retirement benefits for **active** employees. Why? Because they were never explicitly promised by the cities – the courts did. This could be a paradigm shift!
- II. Agencies could “redesign” their retirement benefits to make them affordable and sustainable.
- III. Changing retirement benefits is complex and time consuming – it doesn’t happen overnight. You need to understand options and their pros and cons. You need to start planning now!

Not so fast! Impediments to Change



- CalPERS/CalSTRS/County Plans will all likely require legislation **before** new accruals can be frozen or agency participation terminated
- More litigation (or labor-influenced legislation)
- Current MOUs – Plan for the future
- Hiring and competitive considerations – no one wants to be first to lower benefits, but pay be more important
- No well-articulated “plans” for the future

CALIFORNIA RULE UPDATE

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- Federal & State Constitutions prohibit the State (or local governments) from impairing contracts.
 - In *Kern v. Long Beach* (1947), California Supreme Court holds right of a public employee to a pension benefit is a right based on contract principles.
 - The Court also established that “the right to a pension becomes a vested one upon acceptance of employment.”
- Two step analysis: (1) Is there a vested contractual right, and if so, (2) is the impairment unconstitutional?
- Lower court cases have interpreted the California Rule to prohibit any change in benefits or at least to set a very high bar for changes.
- However, the California Supreme Court has held that prior to retirement, an employee does not obtain “any absolute right to fixed or specific benefits, but only to a substantial or reasonable pension”.

- The Court established that an impairment may be constitutional if:
 - the change is made to keep a pension system flexible to permit adjustments in accord with changing conditions and to maintain the integrity of the system;
 - the change must bear a reasonable relation to the theory of a pension system; and
 - changes which result in a disadvantage to employees should be accompanied by comparable new advantages.

- Cal Fire Local 2881 v. CalPERS (1st District, Division 3)
 - Issued December 30, 2016.
 - Challenges changes made by PEPRA that restricted the purchase of additional service credit (“airtime”).
 - Plaintiffs sought to force CalPERS to continue airtime purchases for classic members; State intervened to defend PEPRA.
 - Borrowing from REAOC, court stated that plaintiffs had a heavy burden to demonstrate that legislation (i.e., the PERL) was intended to create enforceable private contract rights against the State.

- **Cal Fire Local 2881 v. CalPERS**
 - Court of Appeal for First District, Division 3 held that:
 - Classic members have no vested right to purchase airtime service credit, on a prospective basis, under PEPRA.
 - Cites favorably to *Marin* decision.
 - California Supreme Court granted review on April 12, 2017.
 1. Was the option to purchase additional service credits airtime a vested pension benefit of classic members enrolled in CalPERS?
 2. If so, did the Legislature's elimination of the right to purchase airtime violate the contract clauses of the federal and state Constitutions?

Status: Fully briefed, including response to amicus curiae briefs. Hearing not yet calendared.

Government Code Section 31461, as amended by AB 340 (2012) and AB 197 (2012):

(a) [**Unchanged**]

(b) “Compensation earnable” does not include, in any case, the following:

(1) Any compensation determined by the board to have been paid to enhance a member’s retirement benefit under that system. That compensation may include:

(A) Compensation that had previously been provided in kind to the member by the employer or paid directly by the employer to a third party other than the retirement system for the benefit of the member, and which was converted to and received by the member in the form of a cash payment in the final average salary period.

(B) Any one-time or ad hoc payment made to a member, but not to all similarly situated members in the member’s grade or class.

(C) Any payment that is made solely due to the termination of the member’s employment, but is received by the member while employed, except those payments that do not exceed what is earned in each 12-month period during the final average salary period regardless of when reported or paid.

Government Code Section 31461, as amended by AB 340 (2012) and AB 197 (2012):

(2) Payments for unused vacation, annual leave, personal leave, sick leave, or compensatory time off, however denominated, whether paid in a lump sum or otherwise, in an amount that exceeds that which may be earned in each 12-month period during the final average salary period, regardless of when reported or paid.

(3) Payments for additional services rendered outside of normal working hours, whether paid in a lump sum or otherwise.

(4) Payments made at the termination of employment, except those payments that do not exceed what is earned and payable in each 12-month period during the final average salary period, regardless of when reported or paid.

(c) The terms of subdivision (b) are intended to be consistent with and not in conflict with the holdings in *Salus v. San Diego County Employees Retirement Association* (2004) 117 Cal.App.4th 734 and *In re Retirement Cases* (2003) 110 Cal.App.4th 426.

- The effect of the amendments to Section 31461
 - One of few pension reform measures of AB 340 which applies to legacy members.
 - It excludes numerous items of compensation from “compensation earnable” which had been deemed includable under the holding in the 1997 *Ventura* decision.

- Marin Assoc. of Public Employees v. MCERA (First District, Division 2)
 - Decision issued August 17, 2016.
 - At issue were changes adopted by the retirement board which restricted compensation earnable for legacy members.
 - Employees argued that they had a vested right to the continued inclusion of payments formerly included under Section 31461.

- **Marin Assoc. of Public Employees v. MCERA**
 - Appellate decision contains broad policy-based arguments for a change in the law.
 - Court of Appeal held:
 - A modification in pension benefits was not required to be replaced by a comparable benefit.
 - While public employees have a vested right to a pension, a right that is secured at the time of employment, such a right is not to a fixed or definite pension but to a reasonable pension.
 - California Supreme Court granted review on November 22, 2016, but deferred matter pending disposition of *Alameda County*.

Status: On March 28th, the Court deferred further action on *Marin* pending a decision on the *Alameda* case, or until further orders.

- Alameda County Dep. Sheriffs Assoc. v. ACERA (First District, Division 4)
 - Decision issued January 8, 2018.
 - Involves employee associations from counties of Alameda, Contra Costa, and Merced.
 - Plaintiffs challenged changes made by the retirement boards which excluded payments that were previously included in compensation earnable.
 - Argued that the value of these payments should be included in compensation earnable for retirement benefit calculations.

- Alameda County Dep. Sheriffs Assoc. v. ACERA
 - Court of Appeal declined to follow *Marin*, holding:
 - Detrimental changes must have a material relation to the successful operation of a pension system.
 - Minimal impact of a change to the system does not justify the change.
 - California Supreme Court granted review on March 28, 2018.
 - Did amendments to Section 31461 reduce scope of “compensation earnable,” and thereby impair employees’ vested rights?

Status: Fully briefed, hearing not yet calendared.

- McGlynn v. State of California (First District, Division 1)
 - Decision issued March 20, 2018.
 - Judges elected in November 2012 but who took office after January 1, 2013 challenged application of PEPRA
 - Court ruled in favor of State
 - Application of PEPRA dependent on when judges first entered the system not when they were first elected.
 - Estoppel claim did not apply.
 - California Supreme Court granted petition for review on June 27, 2018.

Status: Court deferred further action pending *Alameda*, or until further orders.

- Represent conflicting decisions at the appellate court level on the appropriate vested rights analysis to apply in evaluating the permissibility of reducing pension benefits of current employees.
- Difference of opinion on whether a public agency may be subject to an estoppel claim that promised benefits cannot be changed.
 - Marin/McGlynn – a public agency cannot promise benefits that exceed its statutory authority.
 - Alameda – a retirement board’s plenary authority to administer the system permits it to settle pension disputes.

- **Hipsher v. LACERA (Second District, Division 4)**
 - Decision issued June 19, 2018.
 - Section 7522.72 – Provides for the forfeiture of retirement benefits following a conviction of a felony offense that occurred in the performance of official duties.
 - Hipsher challenged the reduction of his vested benefits based on County determination that gambling conduct was committed in the scope of his official duties.
 - Court of Appeal Ruling:
 - Section 7522.72 is constitutionally sound; but
 - LACERA, not County, must afford Hipsher due process protections in determining whether his conviction falls within the scope of Section 7522.72.

- Hipsher v. LACERA (Second District, Division 4)
 - Legislative deference is broad as even a substantial impairment may be constitutional if it is reasonable and necessary to serve an important public purpose.
 - Section 7522.72 is constitutional because it serves the important public purpose of ensuring the integrity of public pension systems.
 - Observed that a public employee's vested retirement benefits can be defeated upon the occurrence of a condition subsequent.
- California Supreme Court granted petition for review on September 12, 2018.

Status: Court deferred further action pending *Alameda*, or until further orders.

- Decision Issued on September 5, 2018.
- Retirees allege impairment of a vested right with respect to changes made by County of Orange to:
 - Grant Benefit
 - Retiree Pension Subsidy
- 9th Circuit Court held:
 - Grant Benefit – reversed lower court dismissal of complaint holding that retirees sufficiently alleged implied contract for lifetime benefits to survive motion to dismiss
 - Retiree Pension Subsidy – ruled in favor of County.
- Implications for California Supreme Court?

AVOIDING BANKRUPTCY

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Why we have to Have the Bankruptcy Discussion



- Cities expect to spend at least 50% more on retiree benefits in the next 7 years.
- Service insolvency is increasing
- Cities are protecting negative cash flow
- Judges in Stockton, San Bernardino and Detroit have stated pension contracts can be rejected in bankruptcy.

- Employers expenditures will continue to rise faster than revenues.
- Absence of legal or statutory reform will delay needed reform.
- Budgets will remain unbalanced and service insolvency more severe.
- Employers will become more active lobbying for reform.
- Voters will continue pension reform agenda.

What's wrong with bankruptcy?

1. Cost — Legal fees and costs must be paid in cash and are high to the point of being excessive.
2. Time — bankruptcy is time consuming and forces limited staff to take on significant new burdens required by the bankruptcy filing.
3. Perceived reputational risk.
4. Lack of established judicial precedent.
5. Creditors perceive they are forced to fight.
6. Municipal bankruptcies end up in mediation, after a lot of lost time and expense.

- Employers will explore different solutions.
- Employers will modify disclosure of collective bargaining.
- Employers will come to recognize that they can negotiate with bondholders.
- Employers and Employees will become more adept at compromise and mediation out of necessity.

- Introduce formal State oversight, supervision and assistance for troubled municipalities.
- Improve municipal governance and transparency in connection with budget, actual and projected financial performance and results of employee contract negotiations.
- Efficient use of mediation or other structured settlement process that includes bondholders and other capital market creditors.
- Recognition that Chapter 9 bankruptcy a last resort, but a useful tool to implement negotiated resolution.

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