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Mapping A Legal Course in the Unknown Seas of Municipal Bankruptcy in the Detroit, Stockton and San Bernardino cases

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INTRODUCTION: COMPARISON OF CONSTITUTIONAL PROTECTIONS:

- Illinois Const. 1970, Article XIII, Section 5 (“Membership in any pension or retirement system of the State...shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.”);
- Arizona Const. Article XXIX, Section 1(c) (“public retirement benefits shall not be diminished or impaired”).

- Arizona Statutes, Section 38-818: A. ([E]ach member ... is **entitled** to receive a **permanent** increase in the base benefit equal to the amount determined in subsections B and F ... The monthly amount of the **permanent** increase provided by subsection A is determined as follows ...)
- NY Article V, Section 7 (providing that membership in any public pension “shall be a **contractual relationship** the benefits of which **shall not be diminished or impaired**”); Texas Article XVI, Section 66(d)(protecting municipal plans as follows, “On or after the effective date ... **may not reduce or otherwise impair** benefits accrued by a person...”). Ironically, Texas has strong constitutional protections for certain municipal plans but follows the gratuity theory for state employees who lack explicit constitutional protection.
- U.S. Constitution, Article 1, Section 10: No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law **impairing the Obligation of Contracts**, or grant any Title of Nobility.
- The federal cases interpreting the contracts clause permit impairments under limited circumstances if the impairment is reasonable and necessary to an important public purpose.

I. **WHAT IS HAPPENING IN BANKRUPTCY COURT?**

A. **What Are the Facts?**

On July 17, 2013, the City of Detroit filed a petition for protection from creditors under Chapter 9 of the Bankruptcy Code, making it the largest municipal bankruptcy filing in U.S. history. The filing, like those in Stockton and San Bernardino has implications most notably for bond holders and participants in the two city retirement systems.

To date, there is little history regarding the application of the bankruptcy law to municipal pensions. Two high profile bankruptcy cases filed by municipal governments have sharply focused the effect of Chapter 9 of the Bankruptcy Code on pension obligations.

B. A Discussion of the Cases.

The City of Prichard, Alabama became the first city in American history to completely default on its employee pension obligations. Prichard sought protection under Chapter 9 of the Bankruptcy Code relating to municipal debt obligations. The automatic stay prevented pursuit of a number of actions by the city's creditors including its employees. The bankruptcy petition was dismissed as not meeting the test under Chapter 9 and has since made some partial pension payments since the automatic stay was dissolved. The petition was later reinstated after the Alabama Supreme Court ruled that the City had authorization under state law to file. Proceedings in 2013 continued to center on whether the petition should again be dismissed.

Vallejo, California received judicial approval to break its collective bargaining agreements in its bankruptcy proceedings. As Vallejo is a participant in the California Public Employees Retirement System (CalPERS), it has no local retirement plan. The unanswered question from the Vallejo decision is whether a city that rejects a collective bargaining agreement also is relieved of its obligations under a pension plan. Vallejo settled its bankruptcy without impairing its pension obligations.

At issue in both Stockton and San Bernardino is whether the Supremacy Clause of the U.S. Constitution will permit a bankruptcy court to disregard state constitutional pension protections. In Stockton, the court has already relieved the City of certain post-retirement health care obligations. In re City of Stockton, 478 B.R. 8 (Bkrtcy E.D. Cal. 2012). It also held that the pension contract could be impaired. In re City of Stockton, 475 B.R. 720 (Bkrtcy E.D. Cal. 2012)

The City of Stockton reached an agreement in October 2013 with other creditors and will continue in CalPERS with no change in benefits. The City was able to convince the bond holders that the loss of pension benefits would so disrupt the remaining workforce that recovery of the City would be impossible. In re City of Stockton, 493 B.R. 772 (Bkrtcy E.D. Cal. 2013).

Central Falls, Rhode Island was sued in an adversarial proceeding by its teachers' union over the effect of that city's bankruptcy proceedings on retirement benefits when municipal bondholders were protected in the bankruptcy plan at the expense of retired and active employees. Bond holders suffered no loss, while retirees took pension cuts of up to 55%. By contrast, a bankruptcy plan by Stockton, California placed the onus on bondholders and no recommended changes to the City's obligations to the California Public Employees Retirement System.

In San Bernardino, the bondholders are demanding that the pension system "share in the pain" endured by all creditors in bankruptcy who receive less than full compensation. This set the stage for a legal challenge by the bond insurer for a pension obligation bond issue as to the relative rights of bondholders versus pensioners in Detroit as well. The Bankruptcy Judge in October 2013 ruled that San Bernardino was "eligible" to proceed in bankruptcy and lumped CalPERS in with other creditors despite claims by the State that it was immune to such claims. That eligibility issue as it relates to pensions is already on appeal to the U.S. Court of Appeals for the 9th Circuit.

II. WHAT IS DIFFERENT ABOUT DETROIT?

- A.** The Detroit case is of particular significance in that, unlike California, Michigan has an express provision in its state constitution which makes pensions a contract between the employee and public employer. The City and the bondholders contend that the federal law overcomes this state constitutional provision. On July 18, 2013, a state judge in Lansing, the state capital, held that the constitutional provision

expressly prevents the Governor from authorizing Detroit's emergency financial manager from seeking bankruptcy protection.

B. The Ruling.

The federal bankruptcy judge held a lengthy trial to determine if Detroit was "eligible" to file for bankruptcy. The issue is whether the State Legislature in Michigan could authorize a bankruptcy that could affect pensions if the Pensions Clause in Michigan prohibits any law impairing pensions. A ruling on eligibility took place on December 3, 2013.

The Bankruptcy Judge held that despite the constitutional provision, the Supremacy Clause of the U.S. Constitution allowed the Court to treat the pension contract the same as any other contract in bankruptcy - it can be impaired in a plan of adjustment.

C. The Plan of Adjustment and the Pending Appeal.

On February 21, 2014 the City filed a 440 page plan of adjustment outlining in detail the treatment proposed for all creditors, including pensioners.

In summary, the plan proposes reducing general employee benefits between 26% and 30%, which would push nearly a quarter of all retirees below the poverty line. The current plan for existing employees would be replaced with a hybrid plan.

Police and fire retirees, who do not have Social Security, would receive approximately 94% of pension benefits. Current workers would also be placed in a hybrid plan.

No COLAs would be paid for 10 years and a restructuring of the respective boards of trustees' investment authority would be required. In addition the plans would have assumed rates of return of 6.5% for PFRS and 6.25% for the GRS.

On Friday, February 21, 2014, the United States Court of Appeals for the 6th Circuit agreed to hear the legal question of whether Detroit was eligible to file for Chapter 9 with the ability to impair the pension contract.

In March, a revised POA was filed seeking cuts of up to 49% for general retirees and 32% for public safety. In addition, efforts continue to restructure the boards to remove stake holders from having an effective voice in their retirement systems.

Mediation efforts have proposed a substantially less draconian result of 6% cuts for general retirees and loss of the COLA for a period of time and no reduction for public safety, also with a period of COLA loss. Contained within that proposal, however, is a “hard freeze” of accrued benefits.

Illustrating the importance of the eligibility issue on state constitutional rights, amicus briefs in support of the constitutional protections were filed by AARP, TEXPERS, NCPERS, CalPERS, the AFT, and the IPFA.

In early July, the participants in the Detroit pension systems approved the most recent version of the Plan of Adjustment. Police and fire kept 100% of their base benefits and lost most of their COLA benefits, subject to restoration at a future date. General members lost 4% of the base benefit and the suffered the same future COLA reduction.

The appeal of the eligibility argument was stayed by the Court of Appeals in late July, 2014 pending completion of the approval of the Plan of Adjustment by the Bankruptcy Court. An appeal by the insurance company for the City’s bonds against the City concerning whether certain revenues were part of the bankruptcy estate continued and, as of the date this outline was prepared, remains pending a decision.

D. The Real Constitutional Issue.

The real constitutional issue was not a state versus federal sovereignty issue. Instead it had to do with the plain reading of the Michigan Constitution. If the state constitution prohibits laws which impair contract and the bankruptcy law allows a bankruptcy only if state law allows it, then how could Michigan pass a state law which violates its own constitution by allowing the pension contract to be impaired?

III. WHAT DOES THIS MEAN FOR THE CURRENT BATTLE IN ILLINOIS?

- A.** Like Michigan, the Illinois Constitution prohibits any impairment of the Pension Contract. The Illinois Pensions Clause is actually broader than the Michigan clause which addresses “accrued benefits.” While that term is subject to debate as to whether it means benefits earned to date or the formula in effect when a member vests, that is not open to debate in Illinois. The benefit structure in effect when a firefighter is hired is the base benefit which cannot be reduced.

A state cannot file for bankruptcy in Chapter 9 of the Federal Bankruptcy Code. A city cannot file for bankruptcy unless the state government where it is located has passed a law authorizing the filing. Illinois and 26 other states do not have a general bankruptcy filing law for cities. A petition by Washington Park, Illinois was denied in 2010 because Illinois did not have a state law authorizing bankruptcy.

Illinois does have a law for cities in financial distress. The Local Government Financial Planning and Supervision Act, 50 ILCS 320 provides a means for addressing municipal insolvency. 50 ILCS 320/9 (b)(4) allows a commission established under the law to recommend filing a petition. The Bankruptcy Court in the case of *In re Slocum Lake Drainage District of Lake County*, 336 B.R. 387 (Bkrtcy. N.D. Ill 2006) dismissed a bankruptcy proceeding due to the absence of a

commission under the Financial Planning and Supervision Act recommending such a filing and the absence of a general state law authorizing a Chapter 9 petition. Even if the law was found to constitute legislative authorization, the law must still otherwise comport with the rest of the state constitution.

B. The Battle in Illinois.

The Illinois Legislature made an important change in state law when it reduced pension benefits in 2013. It effectively overturned an earlier state Supreme Court decision which said that pension plan members could sue over underfunding. The new law allows suits to force funding if the state fails to meet the statutory funding requirements. Will this new right be a sufficient quid pro quo for the dramatic benefit reductions? The lawsuits have already begun and consolidated into a class action affecting more than 600,000 workers and retirees. In challenges to alteration of retirement benefits, the issue is whether the change is a “diminution.” The theory behind the new legislation is that providing a right to sue for the funding is a “new and offsetting advantage.” The current state of the law in Illinois is that a court cannot order funding. See, *Skłodowski v. State*, 695 N.E.2d 374 (Ill. 1988). Is the judicial right of enforcement a benefit? Is it a lawful surrender of legislative independence to set fiscal policy?

C. The *Kanerva* Decision and its Import

In a very important decision of first impression reached on July 3, the Illinois Supreme Court held that the General Assembly was precluded from impairing or diminishing health insurance subsidies provided to state retirees.

Effective July 1, 2012, Public Act 97-695 eliminated the statutory standards¹ for the mandatory state contribution to health insurance premiums for members of the three state retirement systems. Instead, Act 97-695 required the Director of the Illinois Department of Central Management Services to administratively determine, annually, the amount of health insurance premiums that will be charged. To facilitate the implementation of the new system, Act 97-695 permits the new contributions to be altered through emergency rules. This amendment “fundamentally altered” the state’s obligation to contribute toward the cost of health insurance coverage.

Members of the State Employees Retirement System (SERS), the State Universities Retirement System (SURS) and the Teacher Retirement System (TRS) brought four class actions challenging the constitutionality of the health insurance reduction under various theories including: violation of the Illinois Constitution pension protection clause (Article XIII, Section 5), contracts clause, separation of powers, along with common law claims based on contract and promissory estoppel theories.

The defendants, including the Governor, and State Treasurer moved to dismiss. The trial court granted the motion dismissing all of the complaints. The Supreme Court agreed to allow direct review, permitting the case to proceed straight to the state’s highest court. The Supreme Court also allowed members of the City of Chicago’s healthcare programs to file an amicus brief on behalf of the plaintiffs. The City of Chicago filed an amicus brief on behalf of the defendants.

¹ The standards were set by Public Act 97-695, which eliminated the statutory standards for the mandatory state contribution to health insurance premiums for members of the three state retirement systems. Instead, Act 97-695 required the Director of the Illinois Department of Central Management Services to administratively determine, annually, the amount of health insurance premiums that will be charged. To facilitate the implementation of the new system, Act 97-695 permits the new contributions to be altered through emergency rules.

Plaintiffs argued that the prior law requiring the state to make specified contributions toward health insurance premiums constitutes a benefit of membership in the retirement systems. Plaintiffs further argued that the amendments diminished and impaired membership benefits in violation of the pension protection clause.

The state argued that its contributions to retiree health premiums are not codified in the pension code and are not paid from the assets of the retirement system. According to the state, health insurance premiums are fundamentally different from pension annuities and therefore not covered by the protections of the pension protection clause.

As framed by the Court, the question presented was whether a health insurance subsidy provided in retirement qualifies as a benefit of membership. Holding that it does, the Court observed that health benefits were provided in 1970 when the pension protection clause was adopted by the voters.

While some of the health benefits are governed by group health insurance statutes and others are covered by the pension code, “eligibility for all of the benefits is limited to, conditioned on, and *flows directly from membership* in one of the State’s various public pension systems.” (emphasis added).

The Court gave the pension protection clause its plain and ordinary meaning that all retirement benefits, including subsidized health care are considered benefits of membership in the retirement system and covered by the pension protection clause. If the drafters of the constitutional provision had intended to only protect “core” pension annuity benefits they could have so specified. The Court refused to rewrite the clause to include restrictions that the drafters did not express and the voters did not approve. Because the Court was able to decide the case based on the plain language of the pension protection clause, it did not need to rely on the underlying debates, which nevertheless support the Court’s conclusion. A single Justice

dissented reasoning that the subsidized health insurance benefits are not “pension benefits” based on a narrow reading of the pension protection clause.

Kanerva v. Weems, 2014 WL 2978472 (Ill. July 3, 2014)

IV. PUTTING BANKRUPTCY IN PERSPECTIVE

A. Who Can be a Chapter 9 Debtor?

Not every city can be a debtor in Chapter 9. Only municipalities in states that specifically authorize their municipalities to file can use Chapter 9. States may not file for bankruptcy.

Twenty-four (24) states permit municipal bankruptcy. Most limit the filings to specified specialized service districts such as utility, waste removal, or drainage entities.

B. Recent Use of Chapter 9.

Since 2011 there have only been 33 Chapter 9 filings. Several were dismissed. Since the inception of Chapter 9 in 1937, there have been 651 bankruptcy filings by cities.

There has been no trending toward the use of bankruptcy as a means of avoiding pension obligations.

V. HOW ARE THE RATINGS AGENCIES VIEWING THE ISSUE?

In a recent public statement, a major rating agency observed long-term liability that pension liabilities must be managed.

Focus is on affordability and sustainability with no preference for method of addressing liability.

Important elements of analysis include carrying charge, funding trends; amortization periods and material actions to address liability.

VI. FINAL THOUGHTS ON MUNICIPAL BANKRUPTCY.

The substantial adverse consequences for a community following a bankruptcy generally acts as a strong disincentive. The limits of state constitutional protections for pension are, however, strongly implicated in the pending bankruptcy cases. Already, the leading cases are making their way to two separate federal appeals courts. Ultimately the issue will be settled in these federal courts, or possibly, the United States Supreme Court.

VII. READING THE SIGNS AND OMENS.

Emerging from the trends suggested by bankruptcies and direct constitutional assaults is a clear division in legal thought concerning what is an “accrued benefit.”

Is an accrued benefit just the value of retirement credits earned to the date of a statutory change or does an accrued benefit include the formula itself? The answer seems to be a resounding “it depends” just demonstrated in an decision of the Arizona Supreme Court.

In a closely watched decision, the Arizona Supreme Court issued a unanimous opinion in *Fields v. Elected Officers Retirement Plan*, 320 P.3d 1160 (Ariz. 2014) upholding a trial court decision finding that a reduction in post retirement benefits to retired judges and other elected officials violated the Pensions Clause of the Arizona Constitution.

In 1998, the electors of Arizona adopted constitutional protection for retirement benefits against impairment or diminution. Notwithstanding that

public referendum, the Legislature altered the guaranteed post retirement benefit formula in 2011, causing a substantial reduction in the gain sharing formula. In response, a group of retired judges filed suit claiming that the legislation was an unconstitutional impairment of the pension contract. An Arizona trial court agreed and struck down the law, holding that the post retirement benefit was a vested financial benefit that was directly and adversely affected by the S.B. 1609.

On appeal to the Supreme Court of Arizona, the Retirement System argued that the impairment was financially necessary, applying a traditional federal impairment of contract test which balances the contract against public necessity. The Supreme Court rejected that argument finding that the Pension Clause in the Arizona Constitution was intended to add an additional measure of protection to pension benefits. Perhaps even more important is the Court's finding that the term "benefit" includes the formula by which future payments will be calculated. Otherwise stated, the "benefit increase formula" is itself a protected "benefit."

The Arizona Pension Clause, Article 29(C) of the Arizona Constitution, provides that membership in a public retirement system is a "contractual relationship." The pension clause further specifies that "public retirement system benefits shall not be diminished or impaired."

As a threshold matter, the Court noted that the sitting Justices are not members of the class of retired judges who brought suit. Nevertheless, the Court acknowledged that the Justices are members of the Elected Officials' Retirement Plan and will be eligible for benefits upon their retirement. The Court further observed that no party had asked for their recusal. Even if recusal had been requested, the Court reasoned that the rule of necessity would apply because disqualification would result in denial of the litigants' constitutional right to have a properly presented question adjudicated.

Next, the Court explained that it would apply a *de novo* standard to review S.B. 1609. The Court began by presuming that the amendment was constitutional, recognizing that the plaintiffs bear the burden of overcoming the presumption of constitutionality.

On the merits, the Court began by addressing the argument that the case should be resolved by using only a federal Contract Clause analysis used by the U.S. Supreme Court in *Energy Reserves Group v. Kansas Power & Light*, 459 U.S. 400 (1983). “But accepting this argument would render superfluous the latter portion of §1(C), the Pension Clause, which prohibits diminishing or impairing public retirement benefits.” Accordingly, the Court refused to apply the lower federal standard, which would treat the Arizona Pension Clause as “essentially meaningless.” Similarly, the Court reasoned that the Pension Clause “confers additional, independent protection for public retirement benefits separate and distinct from the protection afforded by the Contract Clause.”

Turning to the benefit formula used to calculate future benefit increases, the Court agreed with plaintiffs that the term “benefit” includes the “benefit-increase formula.” The State and the Plan had argued that the term “benefit” only includes “the right to receive payments in the amount determined by the most recent calculation.” Looking to the history of the Pension Clause, the Court observed that the benefit formula predated the Pension Clause. When the original version sunsetted in 1994, the legislature removed the sunset in 1996 “unqualifiedly extending benefit increases in perpetuity.” Two years later, the legislature reinstated the 4% cap and the voters approved the Pension Clause, affording public retirement benefits constitutional protection in 1998.

The Court also rejected the argument that the Pension Clause only protected liquidated amounts, rather than the statutory formula. Of course, monthly benefits are determined using a statutory formula. The legislature has “never promised to pay a specific dollar amount; rather, it has provided a formula by which the promised amount is calculated.” As the legislature itself demonstrated when it passed S.B. 1609, lowering the benefit requires changing the formula. A contrary interpretation would place the “base benefit” outside the scope of Pension Clause protection because the base benefit is the direct product of a formula. Thus, the promised “benefit” necessarily includes the right to use the promised statutory formula.

In reaching this conclusion, the Court confirmed that its interpretation of the Pension Clause was consistent with prior Arizona cases. In particular, in *Yeazell v. Copins*, 402 P.2d 541 (Az. 1965), the Arizona Supreme Court held that an employee was entitled to have their retirement benefits calculated based on the formula in effect when employment began, rather than a less-favorable formula adopted during employment. Effectively affirming *Yeazell*, the Court held that plaintiffs had a right to “the existing formula by which his benefits are calculated as of the time he began employment and any beneficial modifications made during the course of his employment.”

For additional guidance, the Court looked to the use of the term “benefit” in other states that have similar constitutional protections. For example, New York and Illinois have also determined that benefit calculation formulas are constitutionally protected. Additionally, the Court recognized that unlike the narrowly protections in some states, the Arizona Pension Clause extends broadly and unqualifiedly to “public retirement system benefits,” not merely “accrued” benefits.

After concluding that the benefit formula was constitutionally protected, the Court proceeded with its analysis of whether S.B. 1609’s amendments impaired retirement system benefits. By retroactively preventing the transfer of \$31 million to the Plan’s COLA reserve, only a 2.47% benefit increase was paid in 2011 instead of the expected 4% increase. Moreover, no benefit increase was paid in 2012 or 2013, when a 4% increase would otherwise have been payable.

The Court further observed that S.B. 1609 makes it more difficult for retirees to receive future benefit increases by raising the rate of return required to fund a benefit increase from 9% to 10.5%. By tying benefit increases to the funding ratio, the likelihood of receiving the maximum 4% benefit was further diminished.

The Arizona Court of Appeals applied the *Fields* decision to find that the right to purchase service credit under certain terms was a “benefit” protected from impairment. *Pendergast v. Arizona State Retirement System*, 323 P.3d 1186 (Ariz. App. 2014).

At the same time cases continue in Florida, Texas, California, Colorado, and Ohio over constitutional protection of employee benefits. For the time being, the questions remain unanswered.

At the same time the battle continues in Illinois, a new battle is brewing in New Jersey. In 2010-2011, the New Jersey Legislature engaged in pension reform which would, in part, guarantee a strict funding discipline for the chronically underfunded state retirement systems. At the end of the 2013-2014 fiscal, Governor Christie, faced with a claimed revenue shortfall, defied the express language of the pension funding bill and used the dedicated pension contributions for other state purposes. Immediately thereafter, The Governor vetoed funding for the pension for the 2014-2015. While the appropriation was vetoed, the funding statute remains in effect. The retirement systems have authorized suit against the state to recover the \$4 billion in lost funding.

Even more recently, the Oklahoma Legislature adopted a bill to close some of its defined benefit plans to new members and place new employees in a cash balance plan. The Legislature, did not, however, follow the prescribed procedures for adopting such bills and the legislation is being challenged on that basis. A similar legislative action was disapproved by the Louisiana Supreme Court in 2013 in *Retired State Employees v. State*, 119 So.3d 568 (La. 2013).

IX. CONCLUSIONS

IF YOU HAVE ANY QUESTIONS OR COMMENTS CONCERNING THIS PRESENTATION, CONTACT ROBERT D. KLAUSNER, ESQUIRE, KLAUSNER, KAUFMAN, JENSEN & LEVINSON, 10059 NW 1ST COURT, PLANTATION, FLORIDA 33324, (954) 916-1202, FAX (954) 916-1232, EMAIL bob@robertdklausner.com, WEBSITE: www.robertdklausner.com