Municipal Securities Rulemaking Board
Public Pension Discussion Series

Unfunded Pension Obligations:
Is Chapter 9 the Ultimate Remedy?
Is There a Better Resolution Mechanism?

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- **INTRODUCTION**
  - Present global economic conditions have increased the possibility that many Sovereigns will experience significant cash flow problems and ensuing financial crisis (e.g., Greece, Portugal, Spain, Italy, Ireland, Latvia, Ukraine, Romania, etc.). The major repeating theme is that such Sovereigns have incurred obligations that are unaffordable and unrealistic. Pension benefits have doomed the financial futures of many Sovereigns
  - The Sovereign crisis must be addressed to avoid damaging the Financial Market and to support the perception that Sovereigns (including state and local governments in the U.S.A.) have the ability to manage their financial affairs and thereby avoid unfriendly credit markets going forward and inability to fund the governmental services their citizen expect
  - The problems facing Sovereigns are not new. The ability of states and municipalities in the U.S.A. to be able to meet financial challenges and successfully resolve them provides a guide as to workable solutions for other Sovereigns (state and local) to follow

State and Local Debt
Financial Challenges — Past, Present & Future

- This presentation will study the pension underfunding problem and the alternatives available to state and local government short of a financial meltdown and propose a Public Pension Funding Authority as the preferred means of addressing the Pension underfunding crisis through a Sovereign Debt Resolution Mechanism
- Past history has shown not enough capacity for voluntary change and too many emotional and political overtones to the pension underfunding problem. What is required is a clear recognition of the dire alternative of Chapter 9 bankruptcy and what can be done by the state and local government before suffering the stigma of financial meltdown or the filing for municipal debt adjustments in a Chapter 9 — therefore, the critical need for the Public Pension Funding Authority is apparent

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

A. State and local government workers are approximately 12% of the nation's workforce — 16 million employees

B. While available cash to pay for employee benefits was decreasing, local and state governments sought to meet demand for services by adding more workers faster than other sectors:

   1. Since 1970, state and local employees have increased by over 60% and have increased more than any other percentage of overall government employees (federal, state and local) from 77.8% to 85.6% (between 1970 and 2000)

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

2. Extraordinary Personnel Growth and Future Pension Crisis* (Mortgaging Your Grandchildren)

	NUMBER OF STATE EMPLOYEES	NUMBER OF LOCAL EMPLOYEES	PERCENTAGE OF STATE OF ALL GOVERNMENT EMPLOYEES	PERCENTAGE OF LOCAL OF ALL GOVERNMENT EMPLOYEES
1970	2,755,000	7,392,000	21.1	56.7
1997	4,732,608	12,000,608	24.2	61.4
Percent Increase from 1970	71.8%	62.3%	14.7%	8.3%

Pension obligations for municipal workers do not have priority in bankruptcy and no protection for deferred compensation

- Demand for Funding Now
- In 1995-1996 Orange County Cut Thousands to Balance Budget

* State and local government employees have grown between 1946 – 2008 by 12.7 million employees, faster than the rate of growth in population. In 1946, there were 2.3 state and local government employees per 100 citizens. In 2008, that number was 6.5. Are we less effective? (Grandfather State and Local Government Spending Report by Michael Hodges)

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

C. Meanwhile, demographics and actuarial assumptions have changed and there has been increased attention focused on the ability of state and local governments to pay the accrued costs of benefits for the expanding number of government employees

D. In the United States, the unfunded pension liability of state and local governments is believed to exceed $1 trillion with OPEBs ranging from $300 billion or more. Some economists have suggested that, given a realistic rate of return for investments as compared to the "unrealistic" rate of return on investments projected by State and Local Pension Fund, the real amount of underfunding is closer to $3 trillion or more due to assumptions on earnings on investments. The cost of unfunded health benefits promised to retirees could push the number even higher

E. At the same time, the debt of state and local governments has almost doubled in the last ten years from $1.197 trillion in 2000 to $2.8 trillion in the fourth quarter of 2010. Citicorp contends the market for state and local government debt in the U.S.A. is actually $3.7 trillion with individual holders being $1.8 trillion (rather than $1 trillion) or 50% of the market

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

Wilshire Consulting has released its 2013 Report on State Retirement Systems: Funding Levels and Asset Allocation. The study includes 134 state retirement systems and concludes the following:

- Wilshire Consulting estimates that the ratio of pension assets to liabilities, or *funding ratio,* for all 134 state pension plans was 73% down from 77% in 2011, down sharply from an estimated 85% in 2008
- For the 109 state retirement systems that reported actuarial data for 2012, pension assets and liabilities were $1.825 trillion and $2.660 trillion, respectively. Pension assets shrunk by 1.2% or $21.7 billion in 2012 from $1,847.6 billion in 2011 to $1,825.9 billion in 2012. Pension liabilities grew 4.8% or $122.2 billion. The average underfunded plan ratio of assets to liabilities equals 68% and of the 109 reimbursement systems, 95% of the systems had underfunded pension liabilities to market assets based on reported actuary data for 2012
- Of the 133 state retirement systems that reported actuarial data for 2011, pension assets and liabilities $2.420 trillion and $3.269 trillion respectively, 93% are *underfunded.* The average underfunded plan has a ratio of assets to liabilities equal to 74%

Recent Pension Reform Efforts

- State Efforts:
  - Over 40 states between 2010 and 2012 have addressed pension reform (8 in 2012, 32 in 2011 and 21 in 2010). Between 2009 and 2011, 28 states increased employer contributions and 7 states increased employee contributions for new hires. Also, between 2009 and 2011, 28 states have increased the retirement age and service requirement and 18 have reduced post-retirement benefit increases such as COLA
  - **California**: 2012 pension reform estimated to save between $42 billion to $55 billion over 30 years for CALPERS and $22.7 billion for CALSTRS (CALPERS shortfall estimated to be $90 to $500 billion)

    The Good Points: New employees to contribute 50% of pension costs with increased retirement age of 62. Current workers with a retirement age of 55 with full benefits are subject to labor negotiation, and if no deal by 2018, subject to having revised plan forced on worker

Recent Pension Reform Efforts

The No So Good Part: No hybrid system that included a 401(k) style plan like Rhode Island so public workers would bear some investment risk:

- Nothing done to reduce skyrocketing healthcare costs to worker and retirees
- No requirement of independent members with financial expertise on Board
- No freezing of benefits

Recent Pension Reform Efforts

- **Rhode Island's Pension Reform**:
  - Suspends new cost of living adjustments to retirees until pension funds and systems are better funded but provides for intermittent COLA every five years until 80 percent fully funded in aggregate
  - Moves all but public safety employees to hybrid pension plans
  - Increases minimum retirement age for most employees not already eligible to retire
  - Preserves accrued benefits earned through June 30, 2013
  - Begins to address independent local plan solvency
- Contractual and Legal Challenge:
  - This reform is subject to pending litigation that it is impinging on constitutional and contractual rights of public workers

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Illinois Pension Legislation of 2010

While more extensive reforms are needed, Illinois in 2010 took a step to stem the draconian increase in state pension underfunding. While the 2010 legislation did not solve the Illinois or local government pension crises, leaving untouched the benefits of current employees, the legislation creates reduced pension benefits for new state employees hired after January 1, 2011, including the following modifications:

- Raises the retirement age to 67 with ten years of service for full retirement. Some retirement plans currently allow full retirement at age 55 or even lower
- Raises the early retirement age to 62 with ten years of service for a reduced benefit
- Limits the maximum pensionable salary to the 2010 Social Security wage base of $106,800. Previously there was no limit to the salary from which a worker could draw a pension for any of the pension plans included in the reforms
- Eliminates “double-dipping” by suspending the pension of any retiree who goes to work for a government that participates in another pension system until that employment ends

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The Illinois Bill falls far short of the reforms many have called for, including:

- The legislation does **NOT** reform Chicago or downstate police and firefighters' pension funds, which are some of the worst funded in Illinois but that was addressed in later legislation by increased funding requirements starting 2015-2016
- The legislation allows Chicago Public Schools to take a partial pension holiday totaling more than a billion dollars over the next three years
- The reforms do not include increases to either employer or employee contributions to the pension funds
- The General Assembly and judge retirement funds are exempted from many of the provisions of the reform bill that apply to every other pension fund

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

- **Minnesota, New Jersey, South Dakota and Colorado COLA Reform**
- In 2010, Minnesota, South Dakota and Colorado passed legislation to adjust (i) retirement age, and (ii) pension benefits (lowering or eliminating increases in pension benefits or increasing employer/ employee contributions) to realistic and affordable levels and those pieces of legislation are being challenged in the courts as to impairing pension and retirement rights. The lower courts in Minnesota, South Dakota and Colorado in 2011 have upheld legislation supporting pension benefit cuts. In 2012, New Jersey passed a COLA freeze and Rhode Island's pension reform became effective that includes COLA reform

San Diego, San Jose and Chicago Efforts at Pension Reform

- San Diego
  - Switch new employees to 401(k) style plan – defined contribution
  - Current employees, part of their salaries tied to pension contribution rates are frozen for five years
  - Changes in calculating pension to prevent spiking
  - The transition period will cause the City to pay more in the near term given the new defined contribution plan for new employees but long term it will transition into a defined contribution plan

San Diego, San Jose and Chicago Efforts at Pension Reform

- San Jose – Measure B
  - New hires would have to pay 50% of pension costs in a new plan compared to about 25% paid by current employees
  - Retirement age for new hires is 60 for public safety employees and 65 for all other
  - The actuarial rate for new hires is capped at 2% of worker annual salary with 65% maximum benefit. Benefits based on highest average salary over three years
  - Current employees can opt out of the defined benefit plan and keep benefits earned to date but would switch to new plan with lower rate of growth of benefit and higher retirement age similar to new employee (highest average salary over three years rather than single year)
  - Unions have challenged the reform legislation

San Diego, San Jose and Chicago Efforts at Pension Reform

- California League of Cities Report
  - 152 cities adopted new pension terms
  - 205 cities have asked employees to pay more toward pension costs
  - California League of Cities has noted that pension costs have risen 25% or more in the last three years for most California municipalities
  - By 2013-2014, it will be common for California municipalities to pay 50% of a policeman's salary, 40% of a firefighter's salary and 25% of other workers salaries for pensions
  - Most cities, since 2007 and the economic recession, have had to resort to layoffs, furloughs, reductions in work force, deferral of preventative maintenance on infrastructure and use of one time reserve to get by

San Diego, San Jose and Chicago Efforts at Pension Reform

- Chicago – Police Sergeants' Pension Reform in 2/12/13
  - Contribution Increase: Sergeants contribute 9% of their salary a year to their pension. That percentage is to increase 1% a year for 3 years (up to 12%) starting July 1, 2013. Once pension funding reaches 80% funding level, employee contribution reduced back to 10 percent
  - Retirement age increase to 53
  - Increase in maximum pension annuity from 75 to 80 of final salary at age 64
  - Chicago Police Sergeants voted down the Union/City negotiated Reform Proposal by a vote of virtually 90% against

San Diego, San Jose and Chicago Efforts at Pension Reform

- Avoiding Funding Cliff Legislation: Agreement to support change in 2010 law that required funding Chicago police and fire employee pension funding on actuarially required basis starting 2014 to be sufficient to be 90% funded by 2040. This would require $600 million in spending cuts in 2015. That would be avoided by the change in the Sergeants' Reform Proposal but it was voted down by the Police Sergeants.
- Chicago firefighters and other Chicago Police labor representatives have failed to reach a similar agreement with the City of Chicago

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

This is not a new problem. Historically, pension systems on the state and local level have been at various times underfunded for most of the last 50 years

The average funding ratio has grown and declined over time

PERIOD	FUNDING % OF TOTAL PENSION LIABILITIES
Mid-1970s	50%
1990	80%
2000	100%
2003	77%

- Historically, extraordinary personnel growth plus political pressure contributed to the rise of pension liabilities
- The up market for investments in the late 1990s and between 2003-2007 has helped investor return and narrowed the underfunding gap and the recent market uptick since mid-2009 has also helped
- However, there are implicit obstacles to solving pension liabilities
- There is political pressure to increase pension benefits when current salaries are limited by restricted revenues

* Source: Standard & Poor's, Research: Managing State Pension Liabilities: A Growing Credit Concern, Jan. 2005

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

- State and local legislatures listen and respond to employee unions and increase benefits without providing corresponding sources of funding
- The ever increasing demand for infrastructure improvements and expanded public safety services have more than strained state and local budgets (estimated $3.6 trillion of infrastructure improvement required by 2020)
- Pension obligation bonds ("POB") have masked the real systemic problem that needs to be addressed and have been a "Band-Aid" and short term fix for significant budget loopholes and the consistent current underfunding of pension obligations

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

- Defined benefit plans ("DB") (as compared to defined contribution plans ("DC")) are for the most part doomed to failure – benefits promised cannot easily be provided, especially given the revenue restraints that state and cities face
- The transition to a DC plan is less volatile, more predictable and, if funded currently, far safer
- The transition to DC plan from a DB plan is costly and complicated
- Expectations of government employees and unions are high and not easily changed and efforts to increase employees' contributions are not well received
- Many state constitutions protect pension benefits from being changed retroactively and some prospectively

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

- In the absence of state constitutional provisions, certain states have adopted legislation prohibiting diminishing or impairing public employee pension rights
- A long-term fix is needed to transition DB plans (that don't work) to DC plans and to substitute increases in benefits to meet political needs with zero tolerance for underfunding as a current budget matter or with increasing benefits that have no funding source – approximately 90% of public employee pension plans are defined benefit plans while less than 15% of private pension plans are defined benefit plans

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

- State Constitutional, Statutory Provisions and Case Law – Non-Impairment vs. Required to Save the Pension Plan
- Pension a Gratuity or Vested Right
- Labor Contracts and Pension Plan Flexibility
- Impairment When Change Is Necessary

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

A. Different Approaches. States take different approaches in analyzing the pension rights of public employees and whether those rights can be modified. The chart set forth below summarizes some of these:

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, Hawaii, Illinois, Michigan, New Hampshire, New York	Arkansas, Georgia, Indiana, Nebraska, New Jersey, Oklahoma, Rhode Island, Tennessee, West Virginia	Alabama, Arizona, 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, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, Wyoming

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

B. A non-impairment law is not intended to stretch pensions beyond their elastic limits

Pensions can be and need to be changed, but within certain structures:

1. Right to modify must be clear in legislation, employment agreements and union contract (Rhode Island)
2. Adverse conditions which could lead to the failure of pension plan and the purpose of the legislation justify amendment (Vermont)
3. To balance adverse consequence of actuarially necessary changes to strengthen or improve the pension plan (Colorado, West Virginia)

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

4. Reasonable modifications that bear material relationship to theory of pension system and successful operation (Massachusetts)
5. Certain legislation by its nature cannot bind successive legislation and can be changed (Georgia)
6. 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)
7. 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)

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

C. 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

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

D. The key issue appears to be how can you fund affordable pensions. While states may prohibit impairment of vested rights to a pension, they generally provide no basis to assure annual funding of annual required contribution (ARC) or the source or mechanism of funding. Given the separation of powers, courts have been reluctant or have outright refused to interfere with the legislative or executive powers of state and local governments and order additional or new funding sources for underfunded pensions. The lack of tying pension benefits to dedicated sources of the payment and the absence of limiting pension and OPEB benefits to affordable dedicated sources of funding of the state and local government pension have contributed to the current pension underfunding crisis

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

E. 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 since there are not sufficient tax revenues to pay for essential government services and pay pension obligations
- 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
- 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 financially embarrassed governmental body

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

- 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)

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

F. The Public Pension Authority Solution?

In states that do not authorize a municipality to file under Chapter 9 of the Federal Bankruptcy Code, federal law has not preempted the determination of insolvency and federal law has left it to the individual states to choose how to proceed:

- Under those circumstances, the federal government could create a Special Commission court or authority, or a state can choose to:
  - Establish fact-finding and determining boards, commissions or authorities ("Public Pension Funding Authority") that can determine the critical facts necessary for funding or restructuring unfunded pensions based on the circumstances such as:

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

1. The ability and willingness to increase taxes and to fund pensions can be determined by the Public Pension Funding Authority with recommendations to local government home rule legislative boards (city council, etc.) or by referenda of the local electorate
2. The elected officials, workers and electorate can make an informed decision based on facts determined by the Public Pension Funding Authority as to the ability of the local government body to pay based upon the relationship between (a) the necessity and amount of tax dollars available to pay for essential governmental services and (b) funds available to pay wages and pension benefits. There would be independent, objective and professional determination by the Public Pension Funding Authority whether the wages and pension benefits are reasonable and sustainable by the local government

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

3. Issues of affordability of wages or pension benefits (in light of the costs of essential governmental services) can be determined by the authority and those determinations can be binding on the state, local government and workers in future labor negotiations or resolutions
4. The adverse effect to younger workers by not addressing the issue now can be avoided
5. Either (a) increase in pension funding (if necessary through tax increases, increased contributions by employees or employer or state intercepts) so that the actuarially required payment is made annually by the government body or (b) adjustment of pension benefits and employee contributions so that which can be reasonably paid is paid and the actuarially required payment is made annually

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

6. State pension authorities can establish minimum level of pension funding required ("Target Percentage") and can require mandatory participation in Public Pension Funding Authority review and determine if below Target Percentage has been triggered and inability of the governmental body to sustain over time providing essential governmental services and fully-funded pension benefits and wages ("Governmental Functions Emergency" or "GFE")
7. While government workers and government bodies may voluntarily seek the aid of the pension authority, upon the determination of a GFE, the Public Pension Funding Authority should have the jurisdiction to make any and all determinations related to pensions and obtaining appropriate pension funding at a level that is sustainable while assuring that the local government will have funds available to provide essential governmental services

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

8. The Public Pension Funding Authority will provide transparency and independent fact determination and can recommend increased pension funding or state intercept of taxes otherwise available to the local governmental body to be used for funding pension payments so that they are the actuarially-required payment or, if necessary, determine there must be a restructuring in order to avoid a breakdown of essential governmental services and a GFE. In recommending a restructuring, the pension authority can determine what is affordable and sustainable and recommend changes to the local governmental body and workers or it can be empowered to require such restructuring, if necessary, through a pre-packaged plan in Chapter 9 filing

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

9. The Public Pension Funding Authority answers the unanswerable problem of failing to connect pension benefits to an affordable dedicated source of the annual payment of the ARC while assuming the funding of essential governmental services without pension payment holidays or other smoke and mirror gimmicks that have to date significantly contributed to the pension underfunding crisis

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

G. Other Actions Can Also Help Resolve the Crisis. The Labor Contract or Agreement Should Permit Reductions and Changes that Are Economically Required:

1. The failure to have properly worded pension plan or labor contract can be fatal to voluntary changes. It should permit modification and reduction at least prospectively. *See Sprague v. General Motors Corp.*, 92 F.3d 1425 (7th Cir. 1996); *In re Doskocil Cos.*, 130 B.R. 870 (Bankr. D. Kan. 1991)
2. It is almost impossible to get every employee to agree to change and, absent a Collective Bargaining Agreement, consent of each affected employee is unlikely, especially if the state statute prohibits unilateral reduction or elimination of pension benefits
3. Even with a union, voluntary change is resisted because of the precedent

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

H. Outside of a Bankruptcy Court Order (and possibly the use of Pension Authority), changes of pension obligations (unilateral reductions) are practically and politically unlikely but may provide the best results:

1. Most State Court Judges are elected by those affected, either directly or indirectly
2. This is a local rather than federal matter
3. Most pension plans are subject to State Constitutional or statutory provisions that will not permit the change
4. Pension benefit reduction is obviously unpopular and causes "morale" issues

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

5. But "Necessity knows no laws." Change may be mandated by the Reality of the Situation – If the Pension System will fail, Pensioners receive less, the purpose of the legislation will be frustrated and less is truly more, especially if less is assured
6. 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

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

7. What is needed is a mechanism like the Public Pension Funding Authority that is independent, neutral and determines the essential facts so the debate of unwillingness or inability can be transcended to a mechanism to provide increased funding or adjustment to what can be afforded for full funding of affordable benefits
8. Bankruptcy is not only rare but is accompanied by a stigma that effects all creditor relations of the government and has far reaching negative consequences. Intermediary step that provides the benefits of a neutral, independent determination of fact issues and a mechanism for full-funding of affordable benefit is not only desired but necessary. Otherwise, the ultimate harsh result will be far worse to all

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

A. First determine whether the problem is
   - "Unwillingness to Pay" or "Inability to Pay" problem
   - Unwillingness to Pay can be solved

B. If there is determined to be an unwillingness to pay and there is an ability to pay then there can be a recommendation of an increase in annual pension contributions or increase in taxes to fund them
   - Referendum or legislative action on providing the funds necessary to fund pension obligation

C. While both lead to the same result, the Inability to Pay may require more drastic action

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

D. Voluntarily consenting to rollback of benefits from employees sufficient to solve the problem
   - Not likely and uncertain results
   - If the employees know the worst case, voluntary consent may be possible

E. Encourage voluntary and consensual resolution to the extent possible (as difficult as this may be)

F. Provide the reality backdrop of a Public Pension Authority which can encourage voluntary consensual resolution and, if needed, provide the harsh reality of what can be afforded and paid or the dire consequences of future enforcement of reality including Pre-Package Chapter 9 with even harsher results for all

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

G. What a Pension Authority can help determine:
  - What Is It: "Unwillingness to Pay" or "Inability to Pay"
  - Consensual Rollback of Benefits - When Less Is More
  - Mandated Changes - Actuarially Required When Pension Plan Rescue Is Necessary
  - Whether Voluntary Steps Can Be Taken as Some States Are Doing or Hope to Do:
    - 14 Steps to a Brighter Future (*See* III.I. below)

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

H. Failure to Address the issue now will lead to potentially larger problems later:
   - Defined Contribution vs. Defined Benefit Plans
   - New Employees vs. Vested Employees
   - Mis-use of Contribution Holidays
   - Lack of Dedicated Sources of Funding
   - No Requirements to make Annual Required Contribution ("ARC")
   - The reality of Pensions that are too big to be paid
   - Need for Significant Increase in Employer and/or Employee Contribution

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

I. The beginnings of movement toward a Public Pension Authority Model:

There are some actions that state or local governments can take to attempt to solve pension problem as part of or prior to use of a public pension funding authority and outside of a Chapter 9 or court proceeding (states such as Arizona, California, Illinois, New York, Oregon, Rhode Island, West Virginia and others have considered or taken some of these actions):

1. Review actuarial assumptions to make sure they are realistic and work. Too conservative assumptions can indicate problems that don't really exist and too liberal assumptions may miss a real problem

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

2. Review investment policy and returns so that poor investment policies are identified and changed before it is too late. Arbitrary rules of valuation or investment can contribute to underfunding. Market volatility can provide false comfort as compared to realistic valuation of assets with adjustment for market cycle. Be careful to avoid if possible losses not reflected in valuations and report accurately any deferral of gains
3. Increase sponsor and/or employee contribution to the plan – easier said than done

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

4. Prohibit an increase in benefits without an identified revenue or funding source:
   - Ban special legislation to benefit special employee groups
   - Require legislature to pass budgets that fully fund current pension obligations and pay a fair portion to cover the unfunded pension obligations
   - Eliminate automatic increases in pension benefits and end-of-career mega increases in salary
   - Create new and more independent advisors and retirement boards

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

5. Move from a DB Plan to DC Plan or provide for Adjustable DC Plan benefits if market volatility or investment result will not actuarially justify the higher payout provided employee increased contributions to maintain higher benefit level with fixed employer contribution based on affordability

   Start immediately with new hires and work on developing plan transition to defined contribution for current employees

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

Transition can be accomplished as part of Big Fix - phase out of defined benefit plans and phase in defined contribution plans:

- Issue POB for cash to cure underfunding and transition cost (transition costs from DB to DC plus underfunding dealt with by savings created, by increased contributions, cap on benefits, change from DB to DC, possible arbitrage on taxable bond proceeds and pension obligations as well as additional funding through bond proceeds)
- Use “cure” as motivation for voluntary agreed termination of DB Plan and creation of DC Plan
- If no agreed termination of DB plan, then phase out with new employees

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

6. Eliminate any automatic increases tied to indexes that cause costs or benefits to rise higher and faster than investment return (either a cap on increases in benefits or elimination of any automatic increase not specifically passed with recognized funding source)
7. No new pension benefits without specific dedicated funding
8. Refrain from POB or "Savings Plan" which provides temporary budget solutions but is not a long term fix. Any voluntary rollback of benefits or increase in employee contributions should not equate to effective lowering of contributions by the state or local government
9. Cap specific pension benefits for each employee category for state and local governments so that legislative or executive branches cannot grant end of career or politically motivated and selective increases which are unfair and costly

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

10. Beware of cash out programs or eliminate early retirement programs or money purchase options which may have untested assumptions and most likely cost more than anticipated
11. Change retirement age and years in service to reduce costs
12. Restrict alternative pension benefit to actual “high risk” jobs - public safety (police and fire) with lower age and service requirements
13. Consolidation of Pension Programs and duplication of function
14. Provide “Supervising Adult” designated state official for audit, review, reporting, transparency and accountability — such as the Public Pension Funding Authority

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

J. The voluntary action (14 steps) may not be possible and changes in benefits may not be voluntarily capable of being agreed to between workers and government without additional persuasive mechanism such as the Public Pension Funding Authority:

  – There are limits to the ability to fund given the realities of tax increases and statutory and constitutional limits and caps. There are limits to intercepts of state tax revenues from funds necessary for essential governmental services to fund pension underfunding. The debate as to increased funding versus restructuring benefits based on the ability to pay and the ability to fund pension benefits as well as essential governmental services requires an objective decider of facts. A Public Pension Funding Authority's objective and expert determination of reasonableness and sustainability of pension benefits in comparison to the funding necessary to pay for essential governmental services can be what is needed to objectively put into focus what can be afforded

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

- Delay in reaching a resolution only means increased underfunding lessening the options and decreasing the prospect of funding pension funds
- From the workers perspective, delay in resolving pension underfunding may mean less in the end for pension benefits. The negative effects of a GFE or a Chapter 9 will be less benefits and a financial stigma that will restrict future ability to fund
- Both government representatives and workers and their unions must recognize that delay means less for the workers and a higher price being paid by the municipality especially if all else fails and a GFE occurs or Chapter 9 filing is necessary

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

CONTINUATION OF THE STATUS QUO

WILL NOT LEAD TO A

HAPPY ENDING

IV. A Solution Is Required to Avoid the Inevitable Meltdown

If the problem of pension underfunding is not solved, competing interests will be aligned against each other:

- The Workers' Demand for Full Funding Now. On the one hand, workers will insist that the pension obligations are in fact debt of the unit of state or local government and consider seeking a writ of mandamus to require the state or municipality to levy taxes or take other action to satisfy the debt obligation

IV. A Solution Is Required to Avoid the Inevitable Meltdown

- The Demand to Invalidate Unjustified Pension Obligation. Taxpayers and other creditors including the holders of the state or local government's general obligation bonds will seize on the debt argument. They will likely insist that in committing to make the pension and OPEB payments, the state or municipality violated state constitutional debt limitations which, under state law, such state or municipality does not have the power to violate, or the government has frustrated its fundamental purpose by threatening the ability to provide essential governmental services. As a consequence, any undertaking assumed in violation of state law is invalid. (It has already begun in California as the Superior Court of Sacramento, California has ruled in invalidating bonds issued under the State Pension Bond Act. See Pension Obligation Bonds Committed ex rel. California vs. All Persons Interested in the Matter of the Validity of the California Pension Obligation Bonds To Be Issued, No. 04AS04303 (November 15, 2005). This ruling was upheld on appeal to the California Court of Appeals, 152 Cal. App. 4th 1386, 62 Cal. Rptr. 3d 364 (2007).)

IV. A Solution Is Required to Avoid the Inevitable Meltdown

– The Only Way Out Is Change. Given the dynamics, there likely will be no winners in this battle. Significantly increasing taxes can lead to a revolt on the part of the taxpayer if not a death spiral to state or local government. A real resolution is required, not a bailout. The urgency of the situation will be exacerbated by the retirement of the Baby Boomers. As noted, techniques to correct the situation include yearly Annual Required Contributions (ARC) at a level deemed actuarially sound, the transition from any pension plan that is not affordable or is doomed to fail (unsustainable defined benefit plans versus flexible plans where benefits can vary based on the affordable contribution by government and the variable contribution by employees that may vary the benefits), the freezing of current benefits and the adoption of new programs which specifically include the right to modify if necessary and require increased contributions by employees. Finally, the issuance of pension bonds with dedicated sources of payment pursuant to enabling legislation must be considered

IV. A Solution Is Required to Avoid the Inevitable Meltdown

- Ultimately, in order to provide a capacity for growth and change in those situations where voluntary and consensual resolution has not worked, it will be necessary to make use of a Public Pension Funding Authority that will determine objectively the ability to pay from available tax sources, engage government representatives and taxpayers as well as workers and unions with objective determination of what is affordable and sustainable and the consequences of failure to each
- This may be voluntary or mandatory to avoid or solve a Governmental Functions Emergency (where the government cannot afford essential governmental services and pension funding or where the Target Percentage of minimum funding has not been reached)

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

A. The voluntary steps that governments and workers can take to reach a consensual resolution are always the best. But sometimes past promises, emotions, politics or the inability to see the objective facts will prevent or impair the ability to resolve the problem

B. The use of Chapter 9 – Municipal Debt Adjustment, or for States repudiation of Debt or slow pay or no pay are not desired solutions and have significant financial consequences to the governmental body and its future financial survival

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

C. State receiverships, commissions and boards of adjustment have been used in times of past financial distress to make necessary determinations of inability to pay, to approve plans of adjusted payments and prevent a governmental function meltdown and the serious consequences of impaired governmental services. These quasi-judicial state authorities have addressed financial distress to permit funding or financing of governmental debt when it was financially sound and affordable, provide bridge financing in time of financial illiquidity or determine what level of debt was affordable and provide a means of implementing such plan

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

D. Likewise, given the Pension Underfunding Crisis, Public Pension Funding Authorities can provide a supervised forum to assist in determining critical issues such as:

- What contribution increases are necessary by both public employers and employees?
- Can taxes be raised to fund pensions?
- Are intercepts of state revenue necessary to provide a source of funding?
- Can the annual Actuarially Required Contribution ("ARC") for pension be made or is it unreasonable, unaffordable and not sustainable?
- Will continued funding of ARC cause the government to be unable to fund the costs of essential governmental services?

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

- What cost-cutting measures are required to achieve affordable benefits?
- What past employment benefits are affordable and what ones, if any, are not?
- What adjustments to past employment benefits are mandated to avoid a governmental functions meltdown or GFE?
- What is the minimum acceptable funding percentage for funding pension benefit ("Target Percentage")?

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

E. The Public Pension Funding Authority ("Authority") would have jurisdiction over pension underfunding issues on a voluntary basis. Government and its workers desiring the supervised approach would be able to petition for the Authority's determination that they qualify for assistance. Likewise, the Authority would have mandatory jurisdiction over governmental pensions if the Target Percentage of acceptable minimum funding is not reached or there is or in the Authority's determination is an imminent threat of a GFE, the inability of the government to provide essential governmental services due to the annual cost of funding the ARC for pension and post-employment benefits. The Public Pension Funding Authority mission is to be the supervising forum for determination of critical issues resulting from underfunded pension plans:

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

- Whether past employment benefits (pension and OPEB) are affordable and sustainable while paying the cost of essential governmental services?
- What recommendations, if any, for tax increases by the government to provide additional funding?
- What recommendation of reduction in pension or OPEB benefits are mandated in order to prevent a governmental functions emergency or meltdown?
- Recommend tax increases to fund additional pensions contributions and require the local home rule unit's legislative body (city council et al.) to consider a tax increase or have non-home rule governments have a referenda over a tax increase with full information available on the Authority's determination of the recommendation of tax increases, the affordability of current and future pension costs and whether any pension costs adjustments are necessary

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

- Determine whether an intercept of state tax revenue should be implemented to pay required benefits
- Determine whether arbitration (voluntary or involuntary) should be engaged in
- Determine whether contributions are necessary from both public employees and employers
- Determine what cost-cutting measure or adjustment of pension benefits is necessary to achieve affordable benefits and allow the continued funding of the cost of essential governmental services

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

F. The last two decades have seen in corporate Chapter 11 Bankruptcy corporate pension benefits adjusted to meet demonstrated affordable levels. There have been significant reductions in benefits to allow the reorganized company to survive. Popular solutions from the corporate world include:
   - Change retirement plans for new hires to reduce defined benefit plans, cash balance plans or defined contributions and variations whereby the employer's contribution is fixed and the employee benefit can vary based on the benefit desired by the employee
   - Transfer OPEB obligations from employers to trust administered by employees funded with one-time employer contributions (and if desired by employees, ongoing employee contributions

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

- Freeze the plan and have a new going forward plan for all employees
- Have representation of public employers and employees negotiate affordable cost reduction to existing plans
- The Public Pension Funding Authority can consider these and other creative resolutions and whether given the interests of all, they can be utilized to resolve the pension underfunding problem

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

G. The Public Pension Funding Authority would be created by state legislature (statute) or constitutional amendment as the case may require. Also, a Public Pension Funding Authority could be created on the federal level provided it does not interfere with Tenth Amendment rights of the states. Given the quasi-judicial function independent experts with experience in public pension, debt restructuring and related area should be selected by the highest court of the state or the Constitutional Officers of the state. The state should fully fund the Public Pension Funding Authority as needed. A designated State Constitutional Officer or the Supreme Court of the state shall be responsible for overseeing the Authority and its statutory mission as well as providing staff support. This State Constitutional Officer should be the supervising adult on the topic and responsible for obtaining funding and staffing of the Authority

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

H. Governmental bodies would be able to obtain voluntary jurisdiction over their issue by filing a petition before the Public Pension Funding Authority. The Public Pension Authority would establish guideline criteria that would be the trigger for its mandatory jurisdiction: the determination by the Public Pension Funding Authority that either a government (A) had funding below the Target Percentage of minimum acceptable funding for pension benefits or (B) has suffered a Governmental Functions Emergency whereby the annual payment of the ARC for pension as determined by the Authority would lead to the inability to fund the costs of essential governmental services. Either of these determinations would be an automatic trigger for mandating the supervision by the Public Pension Funding Authority for that government

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

The possible triggers for the mandatory jurisdiction over the pension of a governmental unit, in the Authority's discretion, could include:

1. Governmental unit failed to fund its pension benefits to the minimum acceptable level established by the Authority, or
2. Funding of the ARC for its pension benefits annually would prevent or impair the government's ability to provide essential governmental authority and such condition is likely to continue, or
3. Failure to fund the ARC for its past employment obligations has no justifiable basis in the determination of the Authority, or
4. Governmental unit has a Governmental Functions Emergency and is not providing essential governmental services to its citizen and has underfunded past employment obligations, all at a level determined by the Authority to be material

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

I. The Public Pension Funding Authority would have the powers necessary to resolve the underfunding of past employment benefits including:

1. Recommend tax increase or requiring a referenda on tax increases
2. Intercept state taxes in order to pay ARC and other past employment benefits
3. Recommend reductions in pension or OPEB benefits to prevent governmental functions emergency or meltdown
4. Approve the local government budget

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

5. Require mandatory arbitration which could include (i) making findings and determinations as to the level of employee benefits and whether they are sustainable and affordable by the government recommending benefit level for employees and retirees at such affordable levels and approving settlements of adjusted benefits or other relief appropriate given the circumstances or (ii) adjudicating necessary modifications to employee contracts and approving arbitration decisions
6. Suspend tax limitations or caps and mandate tax increase votes or referenda to provide adequate funding of past employment obligations
7. Increase pension contributions by employer and employees so that the ARC is paid annually and all past employment benefits are adequately funded

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

8. Provide ability to issue bonds to cover a portion of pension or OPEB but only if tied to the enactment of significant pension/OPEB reforms that are determined to be a complete resolution of the problem
9. Transfer the local pension plan to an established statewide plan structured to ensure adequate funding and state intercept of tax authority
10. Authorize the local government to file for municipal debt adjustment (Chapter 9 of Federal Bankruptcy Code) using the determinations of the Authority as the basis for a pre-packaged plan of debt adjustment

V. The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

J. The Public Pension Funding Authority is the last resort before Chapter 9 bankruptcy in order to avoid a governmental functions meltdown. The stigma of Chapter 9 and its harsh consequences can be avoided by use of the Authority. The political or shortsighted views of local government in refusing or failing to fund the ARC when it has the ability to do so and the unrealistic or parochial view of government, workers or their representatives can be clarified in the sunlight of the Authority. A neutral, independent and expert authority will determine the salient facts and the local government and the government workers and their representative will either see the light or suffer the consequence of the determination of the Authority which can be enforced by state courts or Chapter 9 proceeding

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

- States Cannot Go Bankrupt but Can Repudiate Indebtedness as Sovereign
- Local Governments Need State Authorization to File a Chapter 9 Bankruptcy Proceeding (Which may already be given)
- Chapter 9 Cases Deal with Adjustment of Debt not Debt Payment
- Pension and OPEB Obligations Have No Priority and Will Be Paid After Secured Creditors
  - Statutory Liens and Revenue Bonds and Priority Creditors Are to Be Paid First

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

- Courts Have Allowed Alteration of Pension Benefits
  - To Rescue Failing Plan
  - To Change Unworkable Legislation
  - To Balance Rights and Interest

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

A. Absent the use of the Pension Funding Authority the recourse to freefall Chapter 9 or state courts is uncertain and probably unsatisfactory. As noted earlier, 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 impossibility and, in addition, state constitutional provisions may prohibit any reduction in earned benefits:

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

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

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

4. These Principles in Practice. 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. 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) Similarly, 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)

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

5. Other Examples. 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) 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)

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

B. States as sovereign cannot file for bankruptcy under Federal Bankruptcy Code. States can repudiate indebtedness but examples of repudiation are rare. Retired employees could go to Court to enforce pension payments as a contract obligation recognized by State Constitutional provisions:

1. Any repudiation by the state of pension liabilities would be politically inappropriate and adversely affect credit assessment
2. During the Depression (1930's), the inability of state and local governments to have sufficient funds to pay employees resulted in payment by script while others (bondholders) got paid in cash
3. Local governmental bodies may be authorized by state law to file for a Chapter 9 proceeding for municipal debt adjustment or, if a quasi municipal entity such as a municipal hospital or other quasi corporate entity or a conduit financing by a corporation, Chapter 11 may be available to reduce the related pension obligations

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

4. States as a sovereign may make use of Sovereign Debt Restructuring Mechanism ("SDRM") such as:
   - Composition of Creditors
   - Receivership
   - Arbitration
   - Sovereign Debt Tribunal – with independence, expertise, neutrality, predictability to attempt to reach volition of the parties

VII. General Analysis of Chapter 9

A. To be a Debtor in a Chapter 9, an entity must be:
   - An entity that is a municipality
   - Specifically authorized under State law to be a Debtor. Twelve States have Statutory Provisions in which the State specifically authorizes filing (AZ, AR, CA, 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 (AL, 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

VII. General Analysis of Chapter 9

- Willing to effectuate a plan; and
- 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

VII. General Analysis of 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

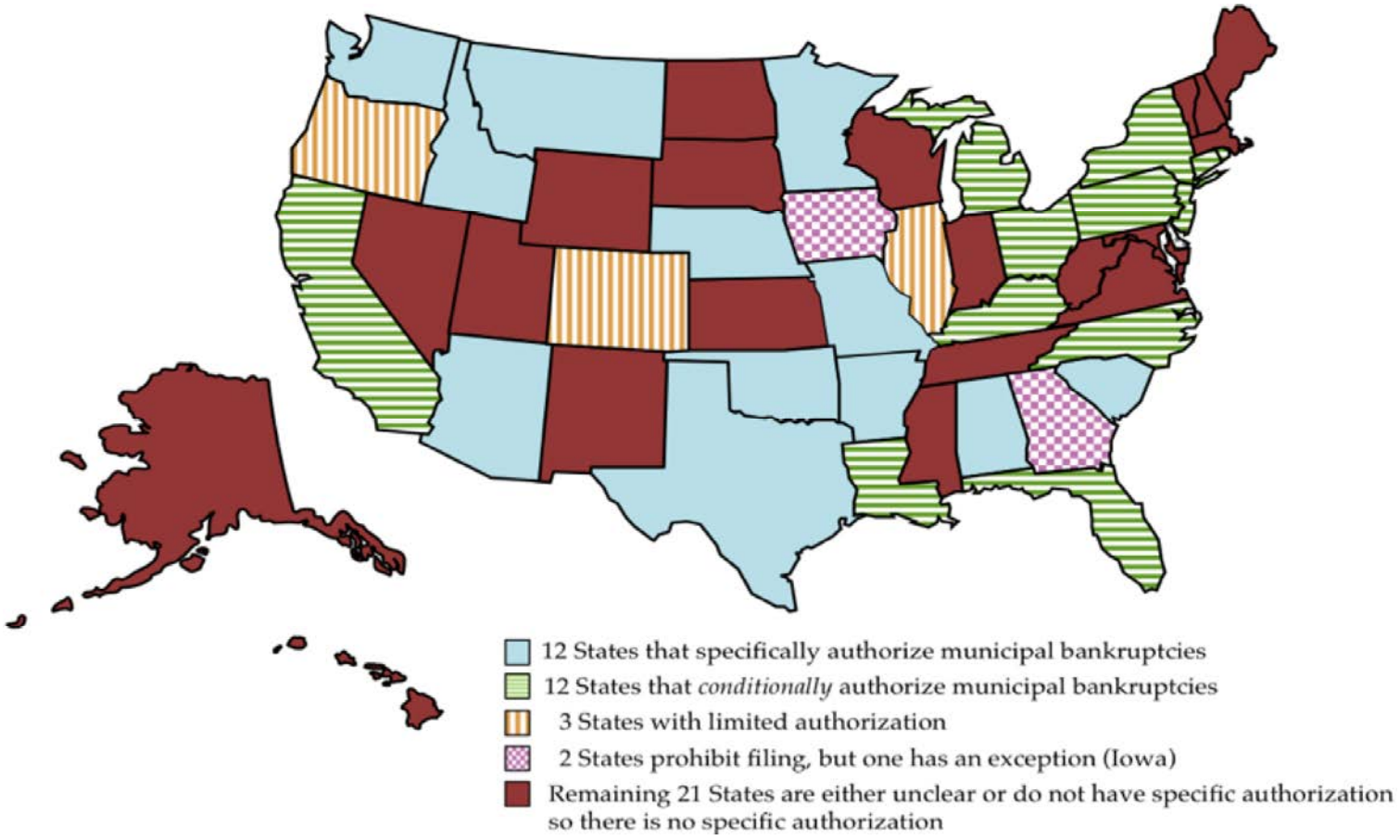
3 States with limited authorization

- 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. 3855/1-20(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)

VII. General Analysis of Chapter 9



VII. General Analysis of Chapter 9

B. No Tsunami of Chapter 9 filings in 2012
   - Only 12 Chapter 9 filings in 2012
   - Only 3 cities, towns, counties or villages in 2012, namely Stockton, San Bernardino and Mammoth Lakes (which was dismissed that year)
   - Total Chapter 9 filings since 1937 – 646
   - Still RARE and mainly small special tax districts, municipal utilities

VII. General Analysis of Chapter 9

C. Alternatives to Chapter 9 still being developed and used
   - Central Falls and Rhode Island demonstrate protection of financing credibility by granting a first lien to public bonds and notes; protect financing and use of receiver can help expedite a Chapter 9 filing if necessary
   - Michigan voted out Public Law 4 – Emergency Manager with extraordinary power on November 6, 2012 and passed in December 2012 the Local Financial Stability and Choice, which gives a financially distressed municipality a choice of (1) entering into Consent Decree with the State (2) agreeing to the appointment of a Emergency Manager (3) agreeing to a neutral evaluation process or (4) filing a chapter 9 bankruptcy petition if so approved by the governor

VII. General Analysis of Chapter 9

- Indiana enacted legislation under which emergency manager may be appointed to oversee a distressed political subdivision in the State. The municipal manager may assume and exercise the authority of the executive or board of the municipality including approving the budget, making expenditures and loans, negotiating labor contracts and reducing or suspending employee salaries and entering into agreements with other municipalities but does not have the power to impose taxes and fees
- Consideration and use of receivers, manager or "supervising adults" increasing in popularity

VII. General Analysis of Chapter 9

D. Stockton, CA:

- Growing trend of challenging the authorization to file but, unlike dismissal in Boise County, ID in 2011, court held Stockton's filing was in good faith and it was insolvent
- CALPERS with city support asserted a priority of pension payments under state law but both deny same priority to bonds and credit enhancers used to finance that obligation

VII. General Analysis of Chapter 9

- The Court recently ruled in the Stockton case that Bankruptcy Rule 9019 does not apply to post-petition settlements made between creditors and Chapter 9 Debtors as municipalities (Section 904 of Bankruptcy Court imposes limitations on Court's jurisdiction. No Bankruptcy Court jurisdiction over property, revenues, political or governmental powers or debtor's use and enjoyment of income producing property). The issue is whether the municipality has unfettered power to settle with some creditors without being subject to review of the fairness and reasonableness of the Settlement by objections of other parties in interest including the State. Can such agreement withstand the test of "fair and equitable" at the time of confirmation of a plan?
- Test of neutral evaluator process in first effort appears controversial

VII. General Analysis of Chapter 9

E. San Bernardino Bankruptcy:

- Ability of municipalities to bypass neutral evaluator by claiming a "fiscal emergency" by adopting a resolution at a noticed public hearing that includes findings that financial state of the municipality jeopardizes the health, safety or well being of its residents absent bankruptcy protection and the municipality is or will not be able to meet its obligations within the next 60 days
- CALPERS' actions to seek permission to sue the City to force it to make pension payments post petition based on CALPERS' state rights and argument that such action by CALPERS is contrary to the Supremacy Law and Federal Law pre-emption
- CALPERS has raised Chapter 9 eligibility of San Bernardino (eligibility appears to be the regular question raised by creditors in a Chapter 9)
- Stockton and San Bernardino are only the tip of the iceberg if relief from unaffordable pension costs is not obtained

VII. General Analysis of Chapter 9

- Popularity of Chapter 9 is inversely proportional to necessity of municipalities to continue to have access to the capital market to borrow funds at a low cost to fund necessary infrastructure improvements and essential government services especially given reduced or uneven tax revenues

The question is: How do recent events affect the financially-challenged municipality find a resolution of its problems and develop a successful recovery plan?

VII. General Analysis of Chapter 9

F. Chapter 9 is not a tool for elimination of municipal debt:
  - Since a municipal unit is intended to continue to provide governmental services in perpetuity and is not intended to liquidate its assets to satisfy creditors but rather continue to function as a municipality, the primary purpose of Chapter 9 is to allow the municipality to continue operating and keep creditors away while it adjusts or refinances creditor claims
  - Adjustment of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan
  - More appropriate to refer to Chapter 9 as municipal debt adjustment rather than municipal bankruptcy

  It is voluntary, a municipality cannot be forced into bankruptcy

VII. General Analysis of Chapter 9

G. Historically the use of bankruptcy by municipalities has been rare:

1. Unlike corporations local governments rarely use Bankruptcy, Chapter 9 – generally only special tax districts and small municipalities file. No large issuers of municipal debt (with the exception of Orange County, California in 1994, Bridgeport, Connecticut in 1991, Vallejo, California in 2008, Jefferson County in 2011, Stockton, California in June, 2012 and San Bernardino, California in August, 2012) have filed in the last 30 years. There have been only 646 Chapter 9 filings since 1937. In 2008, 2009, 2010 and 2011 there were 4, 10, 6 and 13 respectively, municipal Chapter 9 filings. In 2012 there were 12 Chapter 9 filings of which only 3 were cities, towns or counties (Stockton, Mammoth Lakes and San Bernardino). There were 58,721 business (14,745 Chapter 11) filings in the year ending September 30, 2009 and 58,322 business bankruptcy (14,191 Chapter 11) filing in the year ending September 30, 2010

VII. General Analysis of Chapter 9

2. Comparing Chapter 11 corporate reorganization filings to Chapter 9 municipal debt adjustment filings reveals the historical strength, willingness to pay and credit quality of municipal bond debt. In 2009 and 2010, there were over 14,000 Chapter 11 corporate reorganizations filed each year. Since 1937, there have only been 646 Chapter 9 cases filed, most of which have been small special tax district and entities that did not issue municipal bonds
3. Further, of the 646 Chapter 9 municipal bankruptcy filings since 1937, 163 or 25% have been dismissed or closed without a plan of adjustment filed. Since 1980, there have been 277 Chapter 9 filings by municipalities and, of those, 84 or 30% have been dismissed or closed without a plan and only 52 of the 277 have been traditional local governments (town, cities, villages and counties)

VII. General Analysis of Chapter 9

4. Since 1954, there have been 301 Chapter 9 filings but only 62 of them were cities, towns, villages and counties. Of those 62 cases filed since 1954 there were 29 cases (46% of those filed) that were dismissed without a plan of adjustment being confirmed
5. Since 1954 of the 301 Chapter 9 filings of municipal bankruptcy: Virtually all of those municipalities that filed chapter 9 were small or not major issuers of Bond Debt except for Bridgeport, Ct. in 1991, Orange County in 1994, Vallejo Ca. in 2008, Jefferson County Al. in 2011, Stockton and San Bernardino Ca. in 2012. Both Harrisburg Pa. and Boise County Id. In 2011 were dismissed as was Bridgeport in 1991

VII. General Analysis of Chapter 9

6. The largest cities, towns, villages and counties to have filed Chapter 9 bankruptcy in the last 60 years

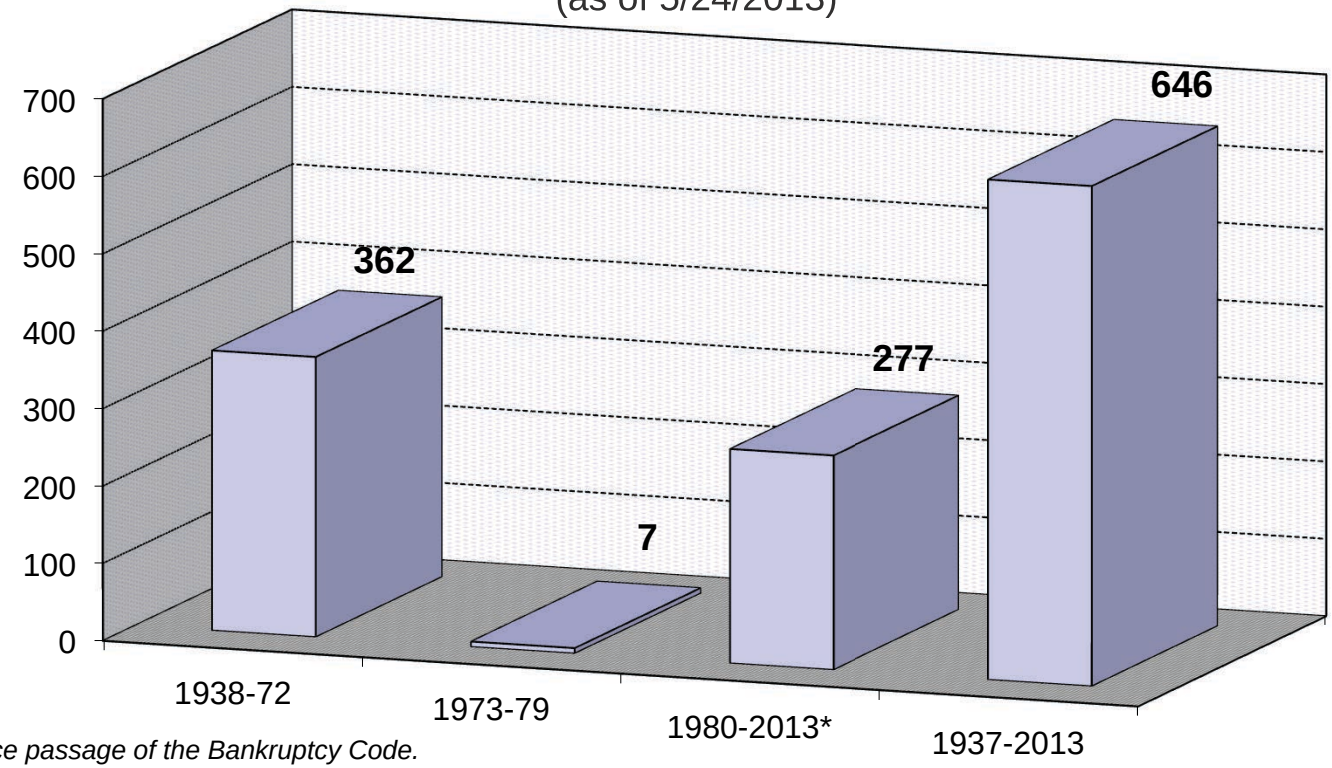
	Approximate Population	Approximate Debt in Millions
Orange County (filed 1994)	3,000,000	$1,974
Vallejo, California (filed 2008)	115,942	$175 (2008)
Jefferson County (filed 2011)	658,931 (2011)	$4,200
Stockton, California (filed 2012)	291,707 (2010)	$1,032 (2011)
San Bernardino (filed 2012)	213,012 (2011)	$492.3 (2011)

VII. General Analysis of Chapter 9

H. Frequencies of Chapter 9 Filings

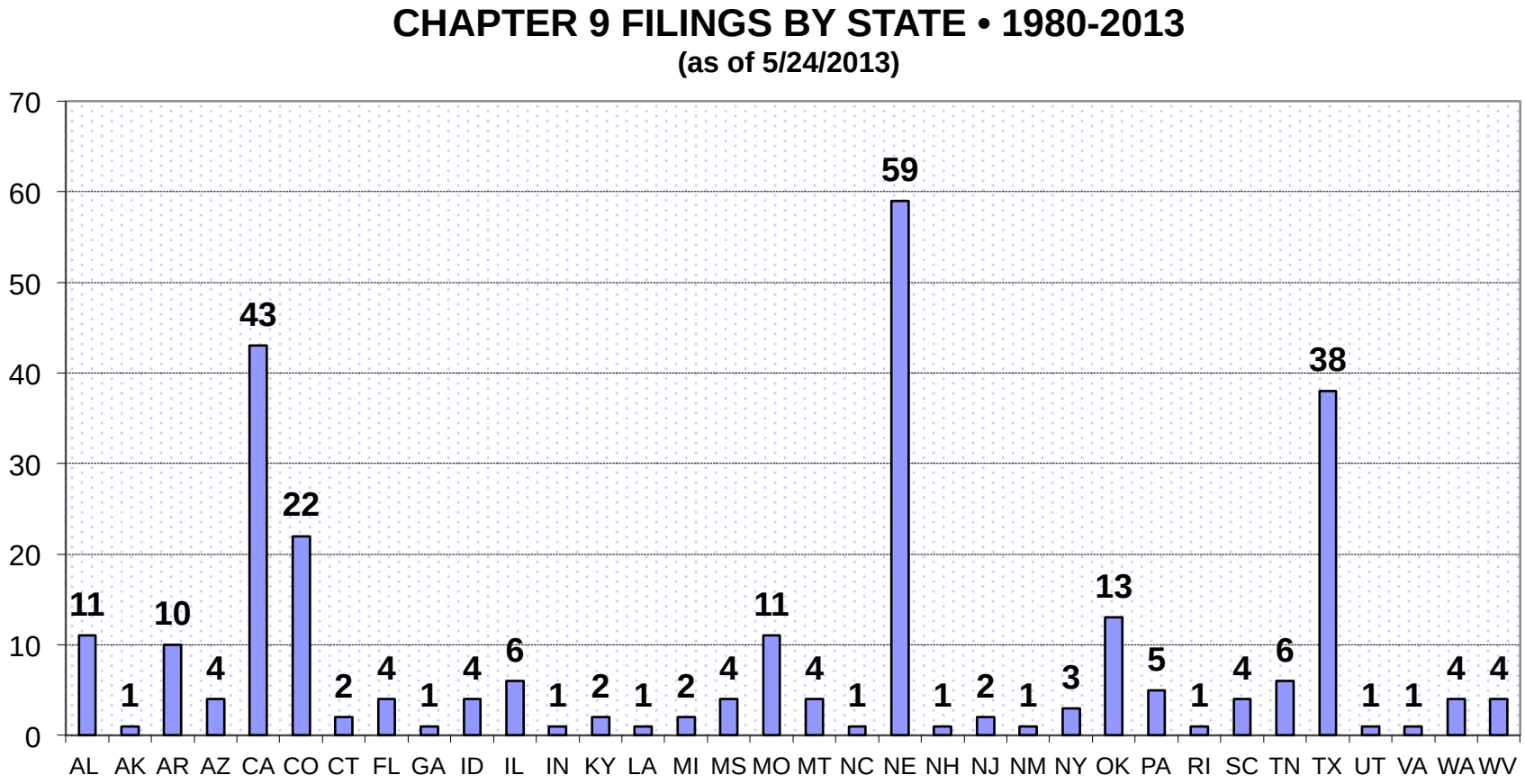
FREQUENCY OF MUNICIPAL BANKRUPTCIES • 1937-2013

(as of 5/24/2013)



** Since passage of the Bankruptcy Code.*

VII. General Analysis of Chapter 9



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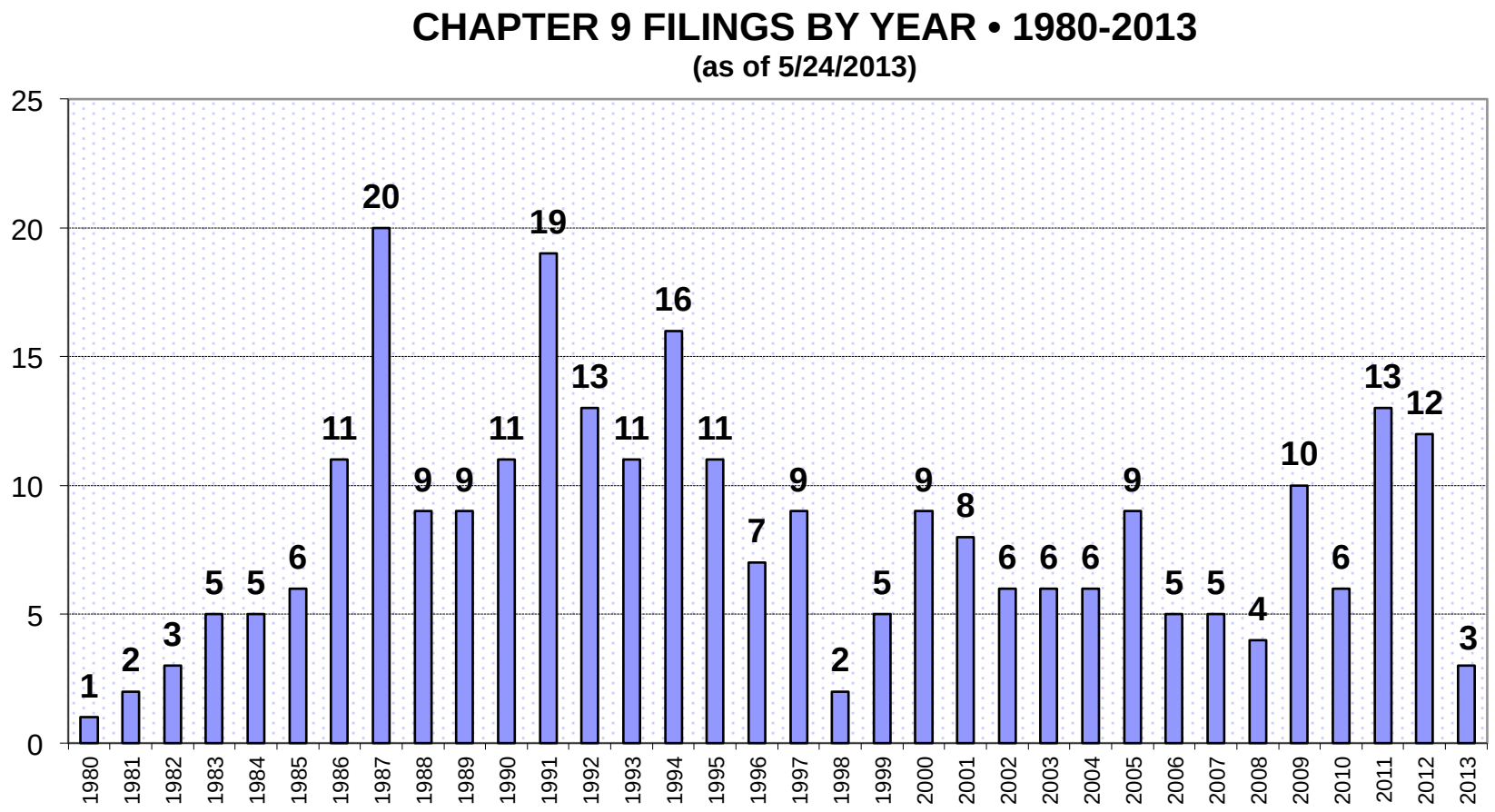

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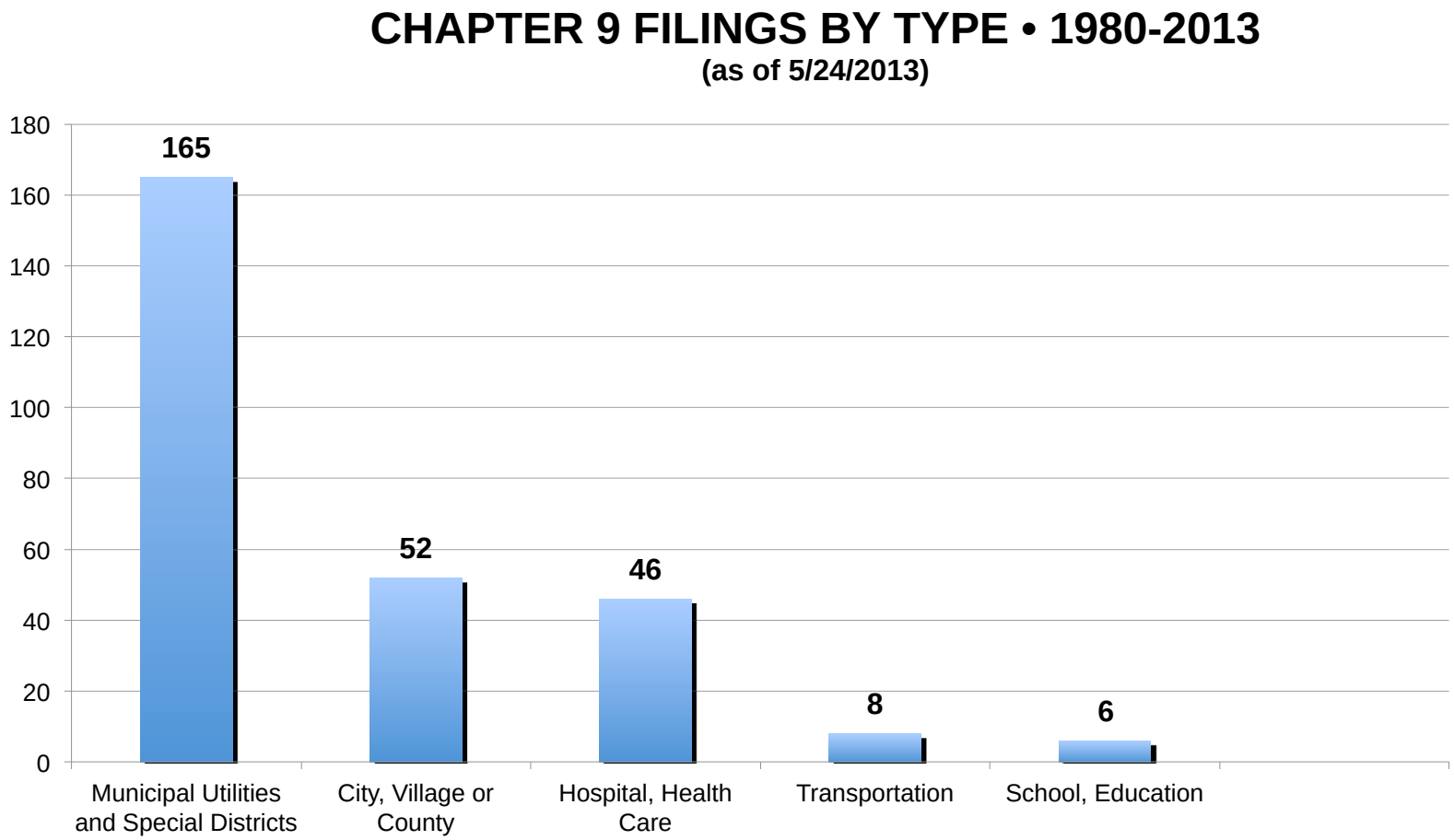

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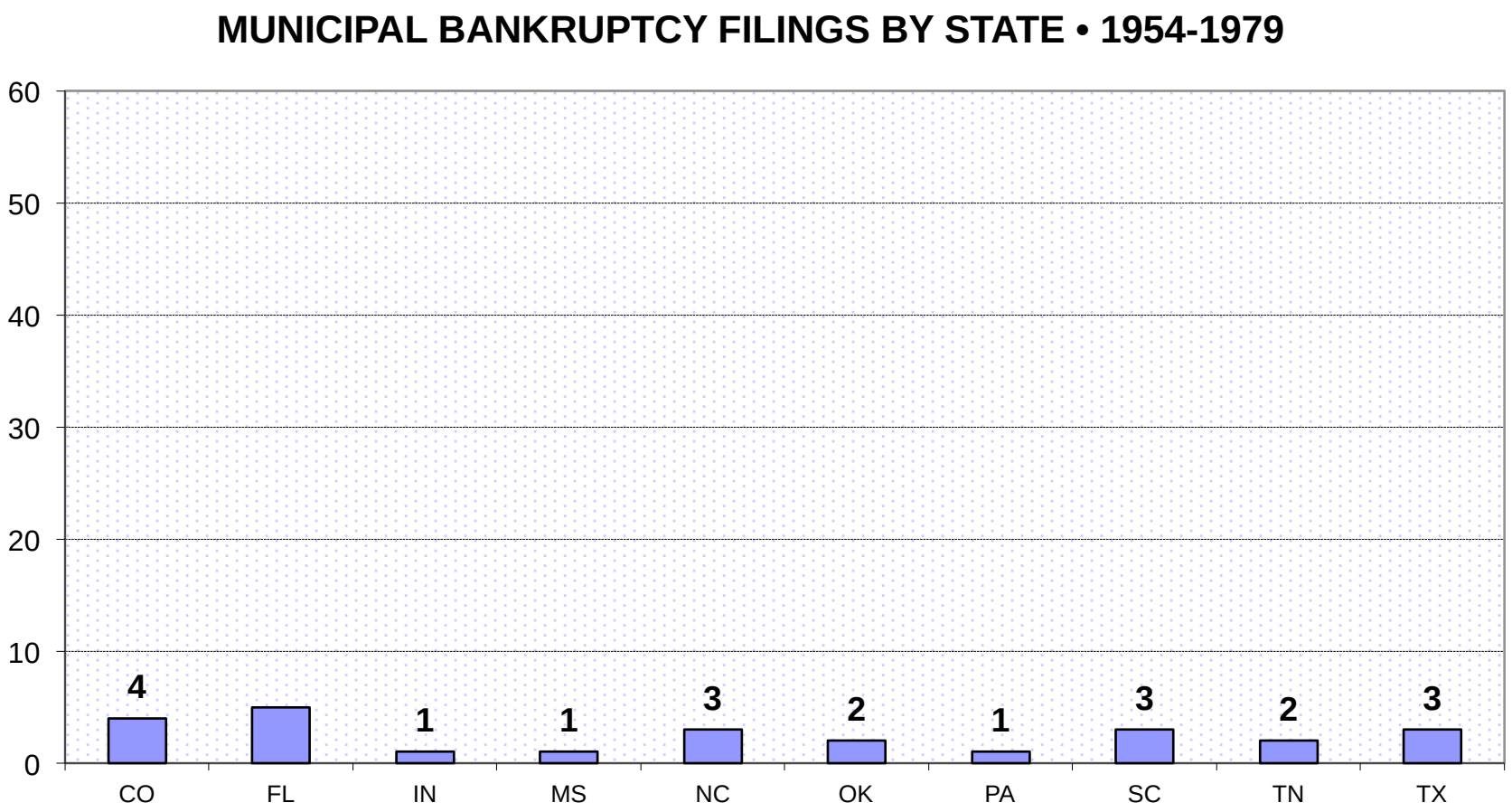

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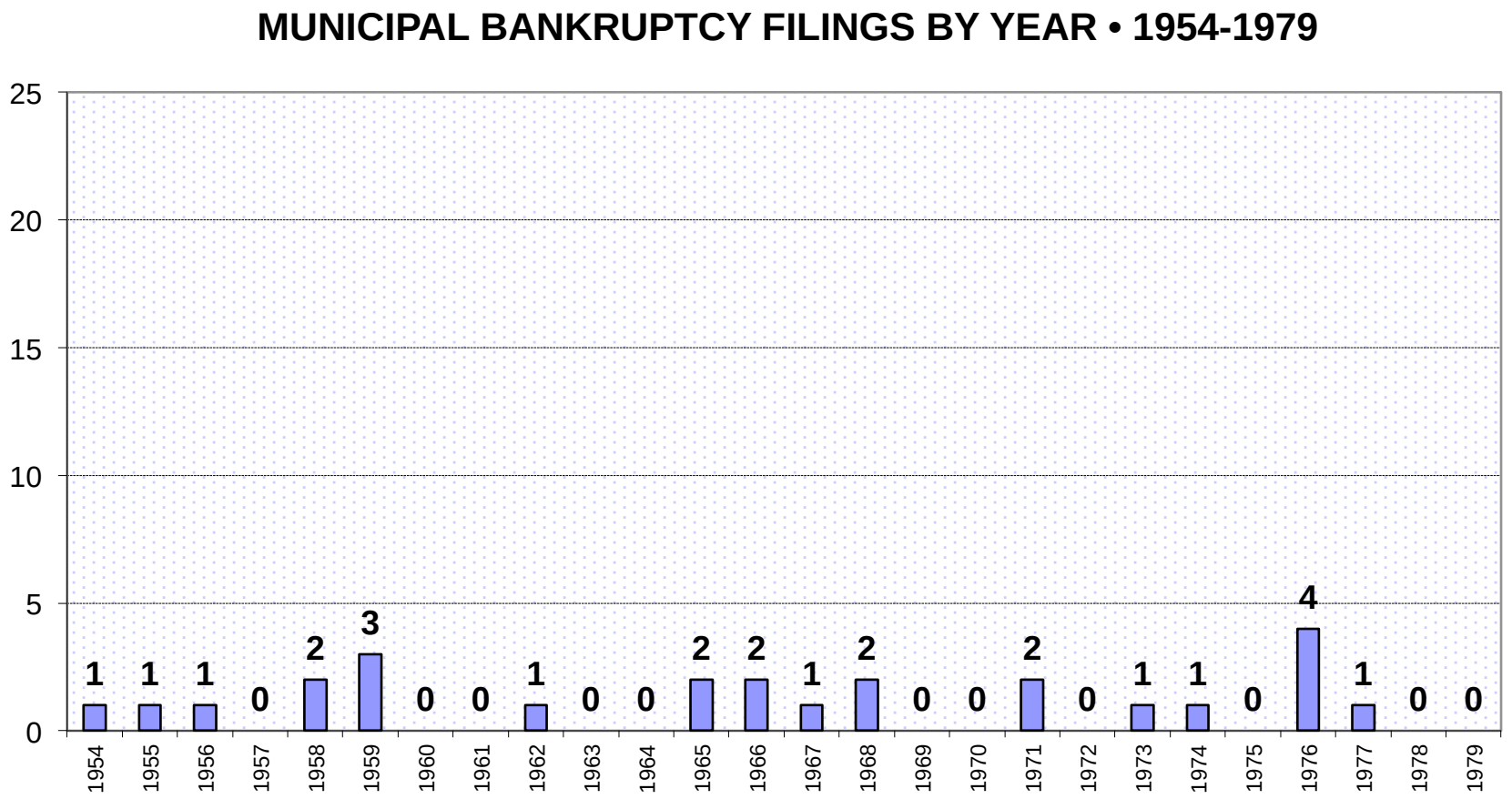

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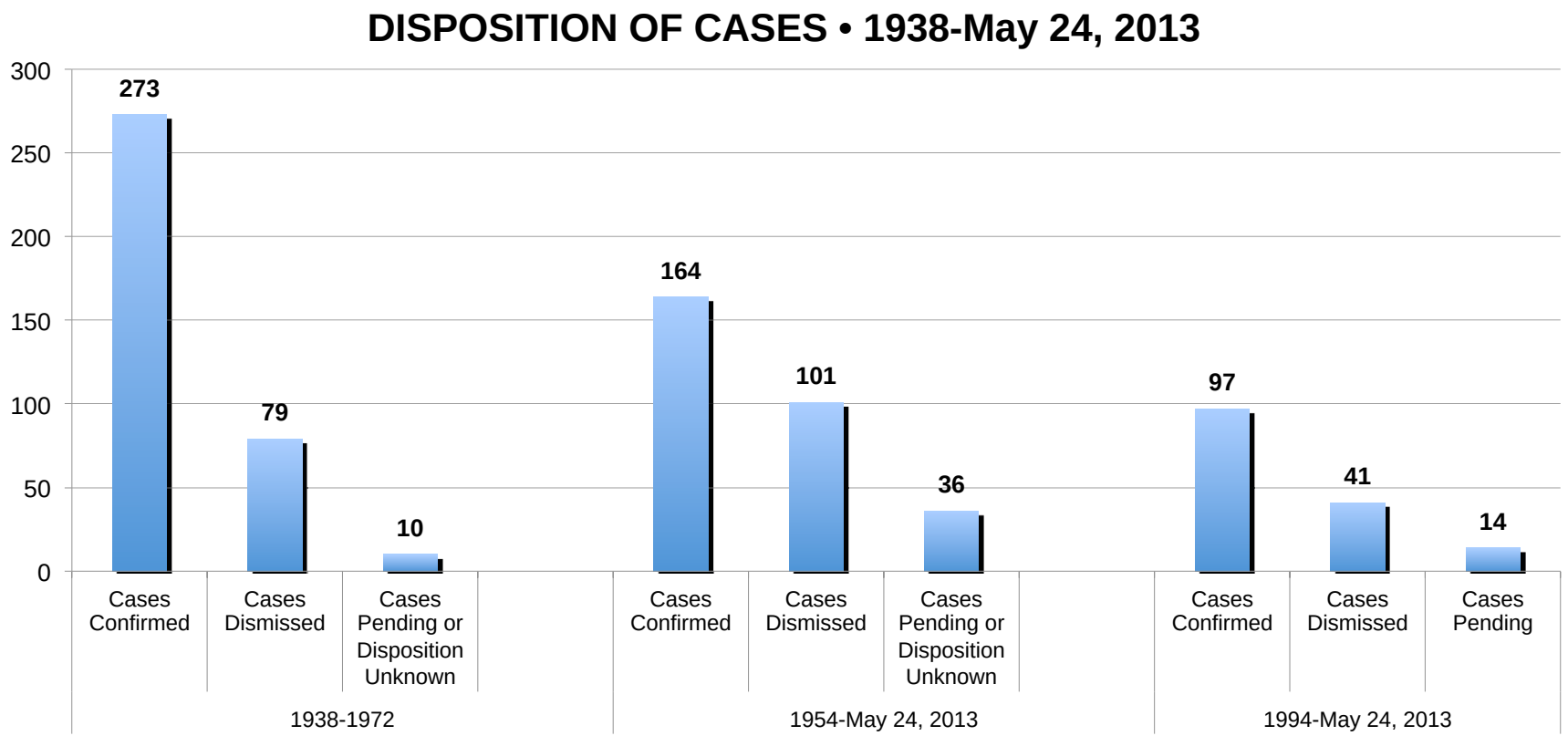

VII. General Analysis of Chapter 9

I. How Is Municipal Debt Treated in a Chapter 9 Proceeding? (Priority of Payment)

Summary of Chapter 9 Priorities

	TYPE OF CLAIM	EXPLANATION
1.	Obligations secured by a statutory lien to the extent of the value of the collateral.[ab]	Debt (Bonds, Trans, Rans) issued pursuant to statute that itself imposes a pledge. (There may be delay in payments due to automatic stay – unless stay is lifted – but ultimately will be paid.)
2.	Obligations secured by Special Revenues (subject to necessary operating expenses of such project or system) to the extent of the value of the collateral.[ab] These obligations are often non-recourse and, in the event of default, the bondholders have no claim against non-pledged assets.	Special Revenue Bonds secured by any of the following: (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems; (B) special excise taxes imposed on particular activities or transactions; (C) incremental tax receipts from the benefited area in the case of tax-increment financing; (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or (E) taxes specially levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor.[c] There should be no delay in payment since automatic stay is lifted under Section 922(d).

a Chapter 9 incorporates Section 506(c) of the Bankruptcy Code which imposes a surcharge for preserving or disposing of collateral. Since the municipality cannot mortgage city hall or the police headquarters, municipal securities tend to be secured by a pledge of a revenue stream. Hence, it is seldom a surcharge will be imposed. (But see Nos. 3 and 4.)

b Chapter 9 incorporates Section 364(d) of the Bankruptcy Code which permits a debtor to obtain postpetition credit secured by a senior or equal lien on property of the estate that is subject to a lien if the prior lien holder is adequately protected.

c A Pledge of Revenues that is not a Statutory Lien or Special Revenues may be attacked as not being a valid continuing post-petition lien under Section 552 of the Bankruptcy Code.

VII. General Analysis of Chapter 9

	TYPE OF CLAIM	EXPLANATION
3.	Secured Lien based on Bond Resolution or contractual provisions that does not meet test of Statutory Lien or Special Revenues to the extent perfected prepetition, subject to the value of prepetition property or proceeds thereof.[c]	Under language of Sections 522 and 958, liens on such collateral would not continue postpetition. After giving value to the prepetition lien on property or proceeds, there is an unsecured claim to the extent there is recourse to the municipality or Debtor. You may expect the creditor to argue that, pursuant to Section 904, the court cannot interfere with the property or revenues of the Debtor, and that includes the grant of security to such secured creditor.
4.	Obligations secured by a municipal facility lease financing.	Under Section 929 of the Bankruptcy Code, even if the transaction is styled as a municipal lease, a financing lease will be treated as long-term debt and secured to the extent of the value of the facility.
5.	Administrative Expenses (which would include expenses incurred in connection with the Chapter 9 case itself).[d] Chapter 9 incorporates Section 507(a)(2) which, by its terms, provides a priority for administrative expenses allowed under Section 503(b). These would include the expenses of a committee or indenture trustee making a substantial contribution in a Chapter 9 case.	Pursuant to Section 943, all amounts must be disclosed and be reasonable for a Plan of Adjustment to be confirmed.

d These expenses strictly relate to the costs of the bankruptcy. Because the Bankruptcy Court cannot interfere with the government and affairs of the municipality, general operating expenses of the municipality are not within the control of the court, are not discharged and will remain liabilities of the municipality after the confirmation of a plan or dismissal of the case.

VII. General Analysis of Chapter 9

TYPE OF CLAIM	EXPLANATION
6. Unsecured Debt includes:	
A. Senior Unsecured Claims with benefit of subordination paid to the extent of available funds (without any obligation to raise taxes) which include any of B, C, D, or E below.	
B. General Obligation Bonds.	Secured by the "full faith and credit" of the issuing municipality. Postpetition, a court may treat general obligation bonds without a statutory lien or Special Revenues pledge, as unsecured debt and order a restructuring of the bonds. Payment on the bonds during the bankruptcy proceeding likely will cease.
C. Trade.	Vendors, suppliers, contracting parties for goods or services. Payment will likely cease for prepetition goods or services.[e]
D. Obligations for accrued but unpaid prepetition wages and pensions and other employee benefits.	These do not enjoy any priority, unlike in a Chapter 11.[f]
E. Unsecured portion of secured indebtedness.	
F. Subordinated Unsecured Claims.	Any debt subordinated by statute or by contract to other debt would be appropriately subordinated and paid only to the extent senior claims are paid in full. Senior debt would receive *pro rata* distribution (taking unsecured claim and subordinated claim in aggregate) attributable to subordinated debt until paid.

e Section 503(b)(9) provides for a priority claim to be paid on confirmation of a Plan for the value of goods provided prepetition within 20 days of the Petition Date.

f Chapter 9 does not incorporate Section 1113 of the Bankruptcy Code, which imposes special provisions for the rejection of collative bargaining agreements (making the standard less restrictive, *i.e.,* "impairs ability to rehabilitate"), or Section 507(a)(4) and (5) which give a priority (before payment of unsecured claims) to wages, salaries, commissions, vacation, severance, sick leave or contribution to pension plans of currently $11,725 per employee.

General Analysis of Chapter 9 Unlike a Chapter 11

- In Chapter 9, only the Debtor can file the case
- In Chapter 9, only the Debtor can file the plan of debt adjustment
- In Chapter 9, there is no Section 1113 criteria for sharing information with employee representatives or workers or any process of information sharing prior to rejection of union or employment contracts
- In Chapter 9, there is no limitation on damages on real estate leases held by a Trustee for a Municipal Building Authority (real estate lease)
- In Chapter 9, municipal bond and note payments made pre-petition, even within 90 days of the filing, are not preferential
- In Chapter 9, there are no priorities for pre-petition wages, benefits, accrued vacation and health care benefits. There is no $12,475 per employee priority claim

General Analysis of Chapter 9 Limitation on the Bankruptcy Court

- The Bankruptcy Court in a Chapter 9 proceeding cannot interfere with the government and affairs of the municipality
- Other than the lack of revenues to pay creditors, municipal services are provided and determined as to whether they will be provided by the governmental body, not by the Bankruptcy Judge
- Unlike Chapter 11, the municipality can sell its assets, incur debt and engage in governmental affairs without necessarily having to obtain the approval of the bankruptcy court

VIII. The Role of Special Revenues in Chapter 9

- Many municipal bonds are revenue bonds secured by a pledge of revenues derived from the project or a special tax levy
- Section 552 of the Bankruptcy Code generally provides that property acquired post-petition is not subject to a lien resulting from any security interest created prepetition
- Section 928 of the Bankruptcy Code, one of the Municipal Bankruptcy Amendments, renders Section 552(a) inapplicable to revenue bonds secured by "special revenues"

VIII. The Role of Special Revenues in Chapter 9

- The security interest in "special revenues" remains valid and enforceable even though such revenues are received after a Chapter 9 filing
- Subsection (b) of Section 928 provides that in the case of project or system financing, the bondholders lien on "special revenues" is subject to necessary operating expenses of the project or system. Thus, these expenses can be put in front of bondholder claims

The Role of Special Revenues

This problem, however, has been addressed by the Municipal Bankruptcy Amendments. Section 927 of the Bankruptcy Code provides that the holder of a claim payable solely from "special revenues" of the debtor shall not be treated as having recourse against the debtor on account of such claim pursuant to Section 1111(b). The legislative history for this section recognizes that many municipal obligations are, by reason of constitutional, statutory or charter provisions, payable solely from special revenues and not from the full faith and credit of the municipality. This amendment leaves these legal and contractual limitations intact without otherwise altering the provisions with respect to nonrecourse financing. Thus, according to the Senate Report, this section avoids the potential conversion of revenue bonds into general obligation bonds

IX. Recent Court Test of Special Revenues/ Statutory Lien Protections

- The 1988 municipal bankruptcy amendment recognizing the postpetition effectiveness of a lien on special revenues brought needed clarity to municipal finance
- Absent such clarification, a risk had existed that a lien on special revenues could be avoided under Bankruptcy Code Section 552(a), effectively turning a revenue bond into a general obligation bond
- Subsequently, given consideration of the Tenth Amendment to the U.S. Constitution reserving power to the states, the *Orange County* bankruptcy produced a decision recognizing that liens created by force of state statute, as opposed to a lien created by agreement of the parties, would survive a Chapter 9 filing
- Few court rulings have dealt with such concepts

IX. Recent Court Test of Special Revenues/ Statutory Lien Protections

- However, recently the Bankruptcy Court in the Eastern District of California has entered an Order in a Chapter 9 case that, for the first time, applies these principles to a financing secured by a special pledge of *ad valorem* property taxes

IX. Recent Court Test of Special Revenues/ Statutory Lien Protections

- In the Chapter 9 case of *In re Sierra Kings*, an insurance company bondholder held municipal securities of a municipal health care district issued for the purpose of financing the renovation of the hospital. The bond resolution provided that, as security for the payment of the bonds, there should be levied, *in addition to all other taxes*, a continuing, unlimited *ad valorem* tax while the bonds were outstanding sufficient to pay the principal of and interest on the bonds when due and that such ad valorem taxes should not be used for any other purpose and should not be paid to the District for any other use. The lien was established in accordance with Chapter 4 of Division 23 commencing with Section 32300 of the California Health and Safety Code and the Enabling Resolution of the District

IX. Recent Court Test of Special Revenues/ Statutory Lien Protections

- The *Sierra Kings* court has entered an order approving the agreement between the District and the bondholder (1) reaffirming the statutory lien on the *ad valorem* taxes levied or collected for the payment of the bonds and the related funds and accounts, (2) granting a replacement lien on such *ad valorem* taxes and such funds and accounts and (3) recognizing such *ad valorem* taxes as "special revenues" as defined in 11 U.S.C. §902(2)(e) of the Bankruptcy Code

IX. Recent Court Test of Special Revenues/ Statutory Lien Protections

- The Reaffirmation Agreement between the District and the bondholder is incorporated into the court order. This constitutes judicial recognition that bonds, notes and other obligations which have pledged to their payment tax revenues which are "Special Revenues" or are the subject of a "statutory lien" shall be paid on time on their scheduled payment date without any interference from the bankruptcy proceeding. In other words, the automatic stay imposed by the Chapter 9 proceeding and the Plan of Adjustment shall not interfere with the payment of the collected tax revenue or the obligations. This means, as collected, the taxes will be paid on time without interference of the bankruptcy proceeding to satisfy scheduled payments on the bonds when due and nothing in the Chapter 9 proceeding, including the Plan of Adjustment, will interfere with that

IX. Recent Court Test of Special Revenues/ Statutory Lien Protections

- The Bankruptcy Court in Jefferson County, Alabama recognized in Opinions in January and June 2012 that special revenues as defined in the Indenture or Authorizing Legislation must be paid to the Bond Trustee for payment to the Bondholders and a Bankruptcy filing does not impair that dedicated payment

X. How is Municipal Bond Debt Treated in a Chapter 9 Proceeding?

A. Summary of Basic Treatment of Bonds and Notes in Chapter 9

TYPE OF BONDS/NOTES	BANKRUPTCY EFFECTS
General Obligation Bonds	Post-petition, a court may treat general obligation bonds without a statutory lien as unsecured debt and order a restructuring of the bonds. Payment on the bonds during the bankruptcy proceeding likely will cease. Prepetition, general obligation bonds are backed by the unlimited taxing power of the municipality (its "full faith and credit") and are historically subject to conditions such as voter authorization, limitations on particular purposes, or debt limitation to a percentage of assessed valuation on the power of municipal entities to incur such debts.
General Obligation Bonds plus Pledged Revenues	Assuming that the general obligation pledge is an actual pledge of revenue and to the extent that it may be classified as a Statutory Lien or Special Revenues, this secured issuance will be respected to the degree it is consistent and authorized under state law. A Pledge of Revenues that is not a Statutory Lien or Special Revenues may be attacked as not being a valid continuing postpetition lien under Section 552 of the Bankruptcy Code. This position may be questioned under Section 904 of the Bankruptcy Code given the prohibition that the court not interfere with the government affairs or revenues of the municipality.
Special Revenue Bonds	A pledge on special revenue bonds will survive a bankruptcy filing. Prepetition, a special revenue bond is an obligation to repay solely and only from revenues of a municipal enterprise (net of operations and maintenance costs) that are pledged to bondholders. The contemplated remedy for default often focuses on a covenant to charge rates sufficient to amortize the debt. Defaulted bondholders are expected to seek mandamus in court to require the municipal borrower to raise its rates.
Revenues subject to Statutory Lien	Assuming the pledge is authorized under state law through a statutory lien, the Bankruptcy Court should respect that statutory lien. Thus, as long as the revenues are subject to a statutory lien, payments to the bondholders should be protected postpetition.

Preferences in Chapter 9

- The Municipal Bankruptcy Amendments not only address the problem of revenue bondholders, but actually provide assurance to holders of all municipal bond or note obligations. Section 926(b) of the Bankruptcy Code now provides that a transfer of property to the debtor to or for the benefit of any holder of a bond or note on account of such bond or note may not be avoided under Section 547. While this section refers to "bonds or notes," there is nothing in the legislative history to support the view that this provision is limited only to instruments bearing such titles. The legislative intent appears to be that Section 926(b) should be applicable to all forms of municipal debt

XI. Other Issues in Chapter 9

Labor Issues

- Burdensome labor contracts can be rejected for cause (City of Vallejo)
- Unfunded pension liabilities are unsecured obligations and no priority for wages, vacation, pension or healthcare in Chapter 9

Non-Bonded Debt or Contracts

- No priority among unsecured claims unless they qualify as administrative
- In a Chapter 9 proceeding, the municipality may assume or reject an executory contract or unexpired lease
- Municipal lease financing presents issue of true vs. financing lease (United litigation)

XI. Other Issues in Chapter 9

Priming of Bonded Debt by

- Necessary operating expenses

Priming of Unsecured Debt by

- Administrative claims

Duration of Chapter 9

- Long enough to accomplish objectives. In complicated actual city or county filing, measured in years

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

No Priority for Pension and OPEB Obligations

Behind Secured Creditors –
Statutory Lien, Revenue Bonds and Priority Claims

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

A. A Chapter 9 proceeding deals with municipal debt adjustment and is and should be the absolute last resort for a municipality:

1. There have been only approximately 646 Chapter 9 proceedings since 1937 (362 between 1937-1972, 7 between 1973-1979, 273 between 1980-2012). The cases between 1937 and 1972 involved only $217 million of debt of which $140 million plus was repaid. Since 1937, 170 of the 645 cases closed without a plan of adjustment being confirmed
2. Generally, only small special purpose tax districts or smaller municipalities file as a last resort but there are exceptions, *e.g.*, Orange County 1994, Bridgeport 1991, etc.
3. It should be a very dire situation that would be a predicate for a municipality's filing of a Chapter 9 to deal with pension obligations

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

B. Unlike a Chapter 7 or 11 proceeding for corporations, in a Chapter 9 there are:

1. No priority for wages, pensions or insurance benefits over general unsecured claims. In Chapter 7 or 11, under §507(a)(4) and (5), $12,475 per employee priority for amounts earned but not made within 180 days of the filing of bankruptcy
2. No provision for special standard and hearing before there can be a modification of labor contract. There is no requirement for a determination after hearing that modification or rejection is so necessary to reorganization that without such modification a reorganization would not be possible. In a Chapter 9, a labor contract can be modified or rejected based upon business judgment that, balancing the hardship of rejection or reduction in benefits, is outweighed by likelihood of "liquidation." For municipality, liquidation is unlikely even though continued municipal operation may be threatened

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

3. No requirement on the municipality to supply sufficient information sharing with employees or unions in order to reject or modify pension or OPEB. Section 1113 and 1114 of Bankruptcy Code are not part of Chapter 9 authorization
4. Accordingly, in Chapter 9, pension benefits and OPEBs receive no special treatment (unlike corporations in Chapter 11) and will be treated and adjusted just like other unsecured obligations
5. Special revenue bonds, interest payments on bonds (prepetition) and statutory liens in favor of bonds and notes shall all be paid prior to unsecured claims including pension benefits and OPEBs without any priority

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

6. Workers and unions might make a constitutional challenge to a Bankruptcy Court's authority to adjust pension benefits asserting that adjustment of pension benefits or OPEBs obligations is unconstitutional. While Sections 903 and 904 of the Bankruptcy Code reserve state power to control municipalities and the Bankruptcy Court has no authority over political or governmental powers of a municipality or its property, revenues or the use and the enjoyment thereof, the Bankruptcy Court in a Chapter 9 has the power to approve a Plan of Debt Adjustment that deals with all contractual obligations. Accordingly, state constitutional provisions regarding pensions are contractual obligations that cannot unilaterally be eliminated or diminished by the municipality. However, this would not appear to prohibit the Bankruptcy Court from approving a Plan of Debt Adjustment in a Chapter 9 if it is specifically authorized by the state or the state/local government, through receivership or oversight authority, may "discharge" that portion of the funded pension liabilities that cannot be paid and still have funds to provide essential governmental services. *See Ashbury Park* case and the *U.S. Trust* case

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

A. $12,475* per Employee Priority Claim Ahead of Unsecured Creditors for Wage, Pension and Health Care Claims Accrued and Unpaid 180 Days Prior to Filing (To be adjusted periodically pursuant to Section 104)

B. Procedures for Information Sharing and Required Court Hearings to Terminate Union Contracts and Pension and Retirees Benefits:
   - To modify as necessary for a Plan of Reorganization or balance of the equities and assure that all creditors are treated fairly and equally (§§1113 and 1114 of Bankruptcy Code)

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

C. There are special priorities and provisions governing labor agreements, pensions and OPEBs and the modification of such:

1. Section 1113 of the Bankruptcy Code deals with the standard for rejection and requires a Court hearing after sharing of all relevant information by the corporation with the unions or employees. The Labor Agreements could not be modified without a Court determination after hearing that reorganization is not possible without modification of the labor contract

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

2. Section 1114 of the Bankruptcy Code provides for a retiree committee and representatives to be appointed to represent the interests of retirees for medical and health care benefits and any modification of existing contracts and benefits can only be done after appointment of the committee and representatives. Modification of medical and health care benefits is permitted when there is a failure of negotiations to obtain a resolution and a Court hearing and determination by the Court that the modification is fair and equitable and the reorganization of the Debtor is not possible without such modification
3. Priority for pension and health care benefits payment not made within 180 days of filing bankruptcy under Section 507(a)(4) and (5) which provides up to $12,475 per employee priority for wages, sick leave, pension and health care payments earned but not paid during 180 days prior to filing

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

D. Process for Terminating Pension Plan

1. Corporate pension plans are employer-sponsored pension plan statutorily vested under ERISA. Municipal and state pension plans are not covered by ERISA but private corporations and "non-municipal" public companies such as private hospitals, could be covered by ERISA
2. ERISA provides for 3 types of terminations:
   - voluntary standard - plan fully funded
   - voluntary distress - plan underfunded
   - involuntary termination - PBGC implemented
3. Any voluntary termination must satisfy certain notice, disclosure and other procedures under ERISA and Bankruptcy Court approval of contract modification

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

4. If union is involved under Section 1113 of the Bankruptcy Code, the termination must have the consent of the union
5. Alternatives to termination of pension plan:
   - IRS funding waiver (generally limited to 2 years)
   - Plan "freezing" benefits and contribution
   - Restoration of funding

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

6. The debtor employer must proceed with 3 concurrent processes:
   - Initiate distress termination proceedings in Bankruptcy Court
   - Proceed with negotiations and PBGC administrative process
   - Administrative filings, disclosures and backup material
   - Formal and informal negotiations with PBGC
   - 60 to 90 day notice to all affected parties of proposed termination
   - Administrative review by PBGC upon requisite findings by Court
   - Section 1113 proposal, disclosure, negotiations and rejection/ modification process, as noted above

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

E. Overview of PBGC Claim in Bankruptcy

1. PBGC has two major and somewhat overlapping claims against bankruptcy sponsors of pension plans, namely:
   - "Plan Asset I Plan (it amounts to the difference between the value of pension plan assets at the time of termination and the value of the pension plan vested obligations to its participants)
   - "Unpaid Funding Contributions" claims which may be a subset of the prior claim
   - In addition, the PBGC sometimes files "premium claims"
   - (PBGC's premium payment regulation requires payments by plan sponsors for the plan year in which termination of an underfunded plan is initiated and for each year thereafter until the plan is terminated and the "insufficiency" claim arising on termination of a pension)

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

2. ERISA Lien – Section 4068 of ERISA creates a lien in favor of PBGC upon all property of any employer who does not pay an obligation arising from unfunded benefit liabilities to the PBGC under ERISA Section 4062-64:
   - Lien cannot exceed 30% of collective net worth of the employer
   - Tax priority if lien not perfected prior to bankruptcy filing up to 30% of the net worth of Debtor
   - PBGC has asserted that if pension plan is terminated prepetition (and the PBGC's lien is not perfected), PBGC asserts an eighth priority under §507(a)(8) of the Bankruptcy Code. Also, PBGC has asserted administrative claim ahead of general unsecured debt payment to the extent the employer's termination liability in excess of 30% net worth increased after filing bankruptcy petition and before pension plan termination. Courts have generally not recognized these PBGC asserted claims as priority or administrative claims and treated them as general unsecured claims

XIV. Conclusion

- The definition of insanity is doing the same thing over and over again and expecting a different result
- The pension underfunding crisis has reached a level of insanity – it is now time for a change, adult supervision and hard determination of what is affordable and what is not
- The use of Public Pension Funding Authorities can provide a determination of the critical issues and a voluntary and, if necessary, mandatory mechanism of resolving pension underfunding as a permanent fix to pay annually affordable actuarially required contributions (payments) that do not compromise the ability to provide essential governmental services

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