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Detroit Bankruptcy Ruling Could Impact San Bernardino Mediation.

LOS ANGELES — U.S. Bankruptcy Judge Steven Rhodes' ruling in the Detroit Chapter 9 bankruptcy that pensions are not in a special class above other creditors could bolster movement already made in that direction in the San Bernardino, Calif. bankruptcy.

The Detroit judge's decision is likely already impacting San Bernardino because the parties were in mediation talks led by U.S. Bankruptcy Judge Gregg Zive of Reno, Nev., hammering out the term sheet for the bankruptcy plan when "a sea change in opinion on whether pensions could be impacted" was handed down, said Karol Denniston, an authority on the California bankruptcies and partner in the San Francisco office of law firm Schiff Hardin.

As part of his favorable ruling on Detroit's eligibility to be in bankruptcy, Rhodes said that Chapter 9 allows the city to cut its pensions, despite state constitutional protections.

Rhodes found in his ruling that Michigan's constitutional protection of pensions does not apply in federal court. As contractual rights, he said pensions are subject to the bankruptcy court's authority to impair contracts.

He added that does not mean he will necessarily confirm a plan that impairs the benefits.

There have been signs that U.S. Bankruptcy Judge Meredith Jury might be willing to impair pensions in the San Bernardino bankruptcy, Denniston said. Jury, who is handling the San Bernardino bankruptcy, asked Zive to oversee mediation on the term sheet. He placed a gag order on the mediation, rendering all discussions confidential.

"If you look at the last paragraph of Jury's ruling when she found San Bernardino eligible to be in bankruptcy," Denniston said. "It looks like she is likely to impact pension contracts because the city has no money."

Judge Jury has asked the California Public Employees' Retirement System why it is fighting so hard when there is no money, Denniston said.

For its part, CalPERS blasted out a press release shortly after the Detroit ruling was announced calling it "short-sighted" and attempting to highlight differences between Michigan and California law.

"Unlike Detroit, CalPERS is not a city pension plan," according to a statement reacting to the decision from the giant pension fund. "CalPERS is an arm of the state and was formed to carry out the state's policy regarding public employees."

The bankruptcy code is clear that a federal bankruptcy court may not interfere in the relationship between a state and its municipalities, CalPERS said.

"The Detroit court failed to recognize the difference between a two-party contract and the unique nature of a state public employee retirement system, which creates a three-way relationship among a public agency, its employees and the retirement system," CalPERS said. "In California, our members' vested rights to their pensions are protected by the California constitution, states and case law."

In federal bankruptcy court, Denniston said, Rhodes' opinion carries a lot of weight, in part because it is the only ruling made on the issue so far. Michigan law is actually stronger on the issue than California, she said, because the protection was added to Michigan's constitution after being approved by voters in 1963.

"That is much stronger than in California where it was read into case law," Denniston said. "We don't have a provision that is as strongly worded as Michigan."

Rhodes opinion, as a bankruptcy judge, could trump previous case law on the issue, she said.

CalPERS' arguments that it is a pension fund, not a pension plan like those in Detroit, also might not be enough.

Although CalPERS functions as a pension plan for its members, the contract between CalPERS and the city is for the pension fund to administer the contract agreed upon with city employees.

"If there is a shortfall, CalPERS doesn't pay, the city pays," Denniston said. "So the cities, which are under their own contract with employees, should be able to renegotiate with city employees consistent with the ruling in Detroit."

Matt Fabian, a managing director with Municipal Market Advisors, said the ruling is specific to Michigan law, its history and related legal precedents; and that a ruling from a judge in California would be needed to set official precedent that applies in the Golden State.

"This likely limits its transferability to other states or pension systems without court interpretation," Fabian said.

The near term effect in San Bernardino is most likely to be political or rhetorical, Fabian said.

"It helps provide political cover to issuers like San Bernardino who are interested in putting losses on pensioners," Fabian said. "But it doesn't set legal precedent. They would need their judge to rule that precedent in Detroit applies here."

Although Fabian doesn't believe the ruling carries formal weight in other states, he did say that the ruling is positive for bondholders.

The ruling means that pensions are not established as superior to other obligations, he said. If pensions can be impacted in a municipal bankruptcy, it could lessen the impact for bondholders, he said. He added it could result in meaningful out of court negotiations between municipalities and unions, which would be beneficial to bondholders.

BY KEELEY WEBSTER

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