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Supremacy's Claws: How Two Judges are Changing the Pension Debate.

The billions of dollars in pension obligations faced by cities and states across the country have politicians from many of them calling for some type of reform. A commission appointed by New Jersey Gov. Chris Christie wants to freeze the state's current pension plan, while in California, Gov. Jerry Brown has signed a bill that increases the retirement age, among other things. In Illinois, Gov. Bruce Rauner wants to eliminate overtime in the determination of pension benefits.

But now rulings by judges in Michigan and California have sparked a debate about another way to deal with pension issues, namely municipalities filing for Chapter 9 protection so that they can break contracts with retirees.

Judge Steven Rhodes of the U.S. Bankruptcy Court for the Eastern District of Michigan in Detroit and, more recently, Judge Christopher Klein in the U.S. Bankruptcy Court for the Eastern District of California in Sacramento, both arrived at a similar conclusion while adjudicating the Chapter 9 filings of the city of Detroit and the city of Stockton, respectively: municipalities can't be stopped from changing or breaking contracts by state law, even if they involve agreements with their pensioners.

"When Judge Rhodes ruled the city was eligible for bankruptcy in December 2013, his opinion pointed out that the Supremacy Clause [in the U.S. Constitution] meant that pension agreements are subject to compromise in bankruptcy court despite their state constitutional protections," said Kenneth Buckfire of Miller Buckfire & Co. LLC, which served as Detroit's financial advisor and investment banker.

Forty-eight states, all but Indiana and Texas, have specific protections for pension accruals. Seven states, including Michigan, put such language in their constitutions. In August 2012, Boston College's Center for Retirement Research reported that the majority of states protect the benefits as a contract, including California. Others label them as property. Minnesota guarantees protection even if there is not an explicit contract.

For now, the two decisions have limited reach. And the process of filing for bankruptcy isn't easy. But officials of cash-strapped governments can be forgiven if they see the rulings as a lifeline.

The two judges, at least, weren't impressed by state protections of something that involves federal law, which governs bankruptcies.

"The state of Michigan itself cannot legally provide for the adjustment of pensions debts or any debts of the city of Detroit," Rhodes wrote. "It has long been understood that bankruptcy law entails impairment of contracts. For purposes of the Tenth Amendment and state sovereignty, nothing distinguishes pension debt in a municipal bankruptcy case from any other debt. e eligibility decision. The state constitutional provisions prohibiting the impairment of contracts and pensions impose no constraint on the bankruptcy process."

Just as the language in Michigan's constitution didn't cow Rhodes, neither does California's protections intimidate Klein, who, on Feb. 4, actually called the Golden State's largest pension fund, the California Public Employees' Retirement System, or CalPERS, a bully.

"[A]s will be seen, it is doubtful that CalPERS even has standing to defend the City pensions from modification," Klein opined. "CalPERS has bullied its way about in this case with an iron fist insisting that it and the municipal pensions it services are inviolable."

The state law forbidding a contract rejection with CalPERS is "constitutionally infirm in the face of the exclusive power of Congress to enact uniform laws on the subject of bankruptcy ... the essence of which laws is the impairment of contracts-and the Supremacy Clause," Klein wrote.

Atlantic City, N.J., could very well become the next battlefield on the pension reform question and whether a bankruptcy filing can help solve it.

Christie on Jan. 22 signed an executive order appointing Kevin Lavin, who previously worked at FTI Consulting Inc., as Atlantic City's emergency manager and Kevyn Orr, who shepherded Detroit through its bankruptcy, as his special counsel.

The seacoast city's main problem is its withering casino industry, but its pension obligations also pose issues.

"I think we are definitely going to continue to see pensions be a focus of municipal bankruptcy, even if it's not the [main] cause of a municipality's filing," said Laura Napoli Coordes, a visiting professor of law at the Arizona State University Sandra Day O'Connor College of Law.

Fox Rothschild LLP partners Nicholas Casiello, Jr., and Michael Viscount, in a Feb. 2 analysis of the city's financial condition, noted that while the emergency manager has said it's too early to discuss bankruptcy, his background in restructuring and the appointment of Orr as Lavin's special counsel has "led to speculation that this alternative is clearly on the table."

For the town once known as The Queen of Resorts to file, the city council would have to approve the step by a two-thirds vote. The state Municipal Finance Commission would also have to clear the move.

According to a 2012 paper from law firm Chapman and Cutler LLP, 12 states have laws expressly allowing one of its political subdivisions to file for bankruptcy, while another 12 states will let a municipality seek court protection upon certain conditions. New Jersey, California and Michigan fall into the latter category. In 21 states, the laws are unclear or do not have specific authorization statutes on the books, while Georgia and Iowa generally prohibit bankruptcy filings.

Not everyone believes that the Rhodes and Klein decisions about pensions being alterable in bankruptcy will firmly take root. Bill Brandt, president and CEO of turnaround consulting firm Development Specialists Inc. and the current chair of the Illinois Finance Authority, said there is "ample debate" as to whether the decisions by Rhodes and Klein would pass muster while under consideration in other courts.

Some in the bankruptcy community may say that retirement benefits can be impaired in bankruptcy court, said Brandt, who has been active in the restructuring world for decades. But, he added, there are "substantial and incredibly important political concerns attached to that."

To be sure, the Stockton and Detroit decisions aren't binding on other municipal bankruptcy cases, said ASU's Coordes.

"[A]s far as the rulings' precedential value, the basic rule is that bankruptcy judges are not bound by decisions of other bankruptcy judges," she explained. "This is true even when the bankruptcy judges are in the same district."

The same holds true for U.S. District Courts.

"But, in general, district court rulings that are not directly related to a bankruptcy court appeal are not binding on the bankruptcy courts," she said.

But district court rulings on bankruptcy appeals are binding, Coordes said.

Stockton's and Detroit's treatment of pensions in those cities' debt-cutting plans were largely left intact. Healthcare benefits took the hit in both plans of adjustment; the coverage was essentially eliminated for both cities' retirees.

Stockton didn't impair its pensions directly, said John H. Knox, the city's debtor counsel from Orrick, Herrington & Sutcliffe LLP.

He said the municipality impaired pensions indirectly by renegotiating contracts and eliminating most medical benefits.

The Stockton plan divides retirees into two categories. The first group received an average of \$24,000 in pension benefits per year with no medical benefits. The second group, which receives \$51,000 annually from CalPERS and \$26,000 in medical benefits, will lose the medical benefit contribution but could pay for the benefits out of their own pockets.

Employees hired before Jan. 1, 2013, will no longer receive free medical benefits but could pay for the insurance out of their own pockets. Employees now pay a portion of the CalPERS contribution, which is 7% for all non-safety employees and 9% for safety employees or sworn police and fire personnel.

The city decided not to change its pension system, in part, to maintain its ability to attract quality employees. Under California law, municipalities are not required to participate in CalPERS, but doing so allows workers the benefit of portability, or taking benefits earned at one CalPERS job to another CalPERS job. Losing that, Knox said, would put the city at an "extreme disadvantage of hiring people."

Stockton also eliminated retiree medical benefits for some, but the city allowed them to participate in its group health plans so they could get lower rates, Knox said.

Detroit, meanwhile, reduced retirement benefits and cost-of-living adjustments slightly for its pensioners.

Under the plan of adjustment, non-uniformed workers participated in the general retirement system and agreed to a 4.5% cut in pension benefits in addition to a loss of future cost-of-living adjustments. Uniformed employees received benefits from in the police and fire Retirement System participants will have no reduction in pension payments, but cost-of-living escalators will be reduced 55%. When it comes the city's underfunded pension plans, Detroit will pay off 60% of it, or \$1.88 billion, over a 40-year period.

Almost all the experts interviewed for this story agreed that a Chapter 9 filing is not the ideal choice, but sometimes there are no alternatives. "I'm fond of saying it's a terrible option until it's the only option," Orrick Herrington's Knox said.

Development Specialists' Brandt said municipal financial turmoil that requires seeking bankruptcy court protection is "a failure of public policy."

Brandt also noted that the Chapter 9 process is more arduous than a Chapter 11. After a company files a Chapter 11 petition, it's in bankruptcy. A municipality, though, must be deemed eligible for bankruptcy by meeting several requirements, including express approval from its state and fulfilling the definition of insolvency under the Bankruptcy Code.

Coordes noted that even though Stockton and Detroit received rulings allowing changes to retirement benefits, the cities took some steps to protect the pensioners. She pointed to Stockton's decision to not reduce current beneficiary payments and Detroit's efforts to bring in private money to help ease pension cuts.

Detroit's debtor counsel, Heather Lennox of Jones Day, said when Motown's professionals began to look the city's finances, the parties did not approach it with a "preordained idea."

"Everyone was going to have to make some sacrifices as a part of this case if the city was going restructure," she said.

Perhaps the most widely discussed aspect of the Detroit case was the so-called "Grand Bargain," which entailed private foundations, the state of Michigan, and the Detroit Institute of Arts each chipping in various amounts of money that eventually amounted to around \$816 million in an attempt to blunt the axing of pensions.

"Consequently, the pension reductions for retirees on account of the [unfunded actuarial accrued liability] are now significantly less than the City had originally concluded would be necessary," Rhodes wrote of the global settlement.

"In many ways this is unique," Lennox said, explaining that Detroit retained "good, solid hardworking people and key industries." She added that history aided them in putting together the joint effort to help shore up the retirement benefits, as the municipality was "kind of a shining city at one time."

Such deals are not likely not to become fixtures in Chapter 9 cases, however.

"There's not enough philanthropic money in the world to bail out all the municipal pensions in this country," she said.

Buckfire said that, while it is true that pension fund benefits only suffered "nominal reductions" under Detroit's plan of adjustment, those were also ultimately achieved through settlements with the unions.

Pursuant to those deals, cost-of-living adjustments to pensions were either cut out completely or reduced by more than half, depending on the pension plan, and retirees gave up health care coverage in exchange for coverage under Affordable Care Act. This resulted in net reductions of \$6 billion out of \$7 billion in debt cut under the plan, he said.

Little more than seven years ago, the idea of touching pensions in bankruptcy "was treated as a little short of crazy," said bankruptcy historian David Skeel, currently a visiting professor at Harvard Law School.

But the Detroit and Stockton cases were not the first time cities flirted with impairing pensions, Skeel wrote in an October 2013 paper for The Federalist Society's White Paper Series. Most

prominently, Central Falls, R.I., which filed a Chapter 9 petition on Aug. 1, 2011, cut its pensions by roughly half and the city's retirees and employees agreed to it.

"One thing we now know, with significant confidence, is that pensions can be restructured in bankruptcy," Skeel noted.

Indeed, as the nation's cities battle financial issues and increasing pension obligations, filing for Chapter 9 protection will loom as a true alternative. And if that's the case, retirees in those cities under distress yet to come had better hope that they can get as good a result as those in Detroit and Stockton, even with the strict rulings of the bankruptcy judges in those cases.

THE DEAL PIPELINE

by contributor Andrew Hedlund | Published March 11, 2015 at 1:17 PM

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