The Federal Reserve Bank of Chicago

Unfunded Pension Obligations: Is Chapter 9 the Ultimate Remedy?

Is There a Better Resolution Mechanism?

The Case for a Public Pension Funding Authority

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

- 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

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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.

“PENSIONS ARE PROMISES THAT ARE NOT TO BE BROKEN” – Saying on T-Shirt of Union Employee in a Corporate Bankruptcy

- To Keep Pension and OPEB Promises that Should Be Kept We must:
  - Recognize the Problem
  - Determine the Ability to Pay
  - If Necessary, Restructure the Payments with an Assured, Dedicated Source of Funding for Realistic and Attainable Benefits

Summary of Key Factors

I. THE PENSION AND OPEBs CRISIS – THE HARD FACTS

- State and Local Public Employees are approximately 12% of the U.S. Workforce and have an Estimated $1 Trillion of Unfunded Pension Liabilities not Counting other Post-Employment Benefits (“OPEB”) Liabilities
- Private/Corporate Workers make up over 80% of the U.S. Workforce and have an estimated $450 Billion of Unfunded Liabilities
- Failure to Address the issue now will lead to potentially Larger Problems later

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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. The Advent of Proposition 13 and other lower tax initiatives and movements which have gained strength since 1970 have the effect of lowering revenues and available dollars to pay off-balance sheet liabilities such as pension underfunding and other OPEBs

C. While available cash to pay for employee benefits was decreasing, local and state government 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%

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

D. 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

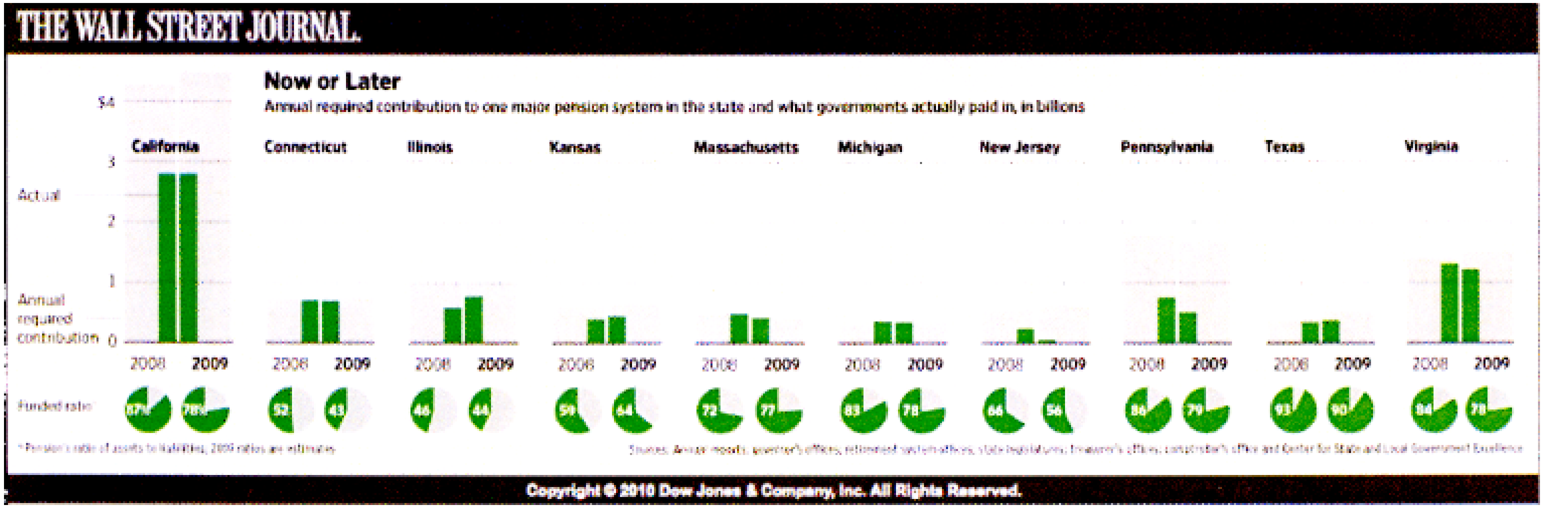
E. In the United States, the unfunded pension liability of state and local governments is intended to exceed to $1 trillion with OPEBs ranging from $300-700 billion. The cost of unfunded health benefits promised to retirees could push the number even higher

F. 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 $2.362 trillion in the fourth quarter of 2009

I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - **THE** CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

G. Statistical Studies

According to a study by the Center for State and Local Government Excellence and the Center for Retirement Research, as reported in *The Wall Street Journal,* in 2009 only 43% of pension plans for states and local governments had assets totaling at least 80% of their liabilities or over a majority, 57% of pension plans, had 20% or more of liabilities underfunded. The payments actually made by states was typically substantially less than the required contribution

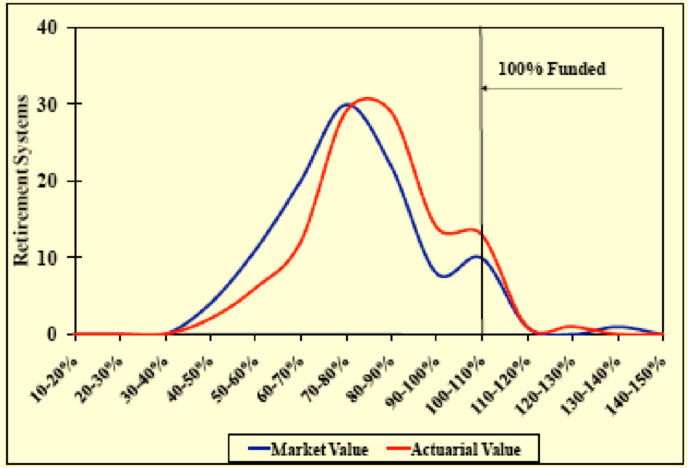


I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - **THE** CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

Wilshire Consulting has released its 2010 Report on State Retirement Systems: Funding Levels and Asset Allocation. The study includes 125 state retirement systems and concludes the following:

- Wilshire Consulting estimates that the ratio of pension assets-to-liabilities, or *funding ratio,* for all 125 state pension plans was 65% in 2009, down sharply from an estimated 85% in 2008
- For the 107 state retirement systems that reported actuarial data for 2008, pension assets and liabilities were $1,601.2 billion and $2,025.3 billion, respectively
- Of the 107 state retirement systems that reported actuarial data for 2008, 89% are *underfunded.* The average underfunded plan has a ratio of assets-to-liabilities equal to 74%.

Distribution of 107 State Pension Systems by FY08 Funding Ratio *



	Bucket Count			
Distribution	Market Value		Actuarial Value	
	Count	% of Total	Count	% of Total
0-50%	4	4%	2	2%
50-60%	11	10%	6	6%
60-70%	20	19%	12	11%
70-80%	30	28%	29	27%
80-90%	22	21%	29	27%
90-100%	8	7%	14	13%
100-110%	10	9%	13	12%
110-120%	1	1%	1	1%
120-130%	0	0%	1	1%
130-140%	1	1%	0	0%
140-150%	0	0%	0	0%
Total	107	100%	107	100%

	Cumulative Count			
Distribution	Market Value		Actuarial Value	
	Count	% of Total	Count	% of Total
0-50%	4	4%	2	2%
0-60%	15	14%	8	7%
0-70%	35	33%	20	19%
0-80%	65	61%	49	46%
0-90%	87	81%	78	73%
0-100%	95	89%	92	86%
0-110%	105	98%	105	98%
0-120%	106	99%	106	99%
0-130%	106	99%	107	100%
0-140%	107	100%	107	100%
0-150%	107	100%	107	100%
Total	107	100%	107	100%

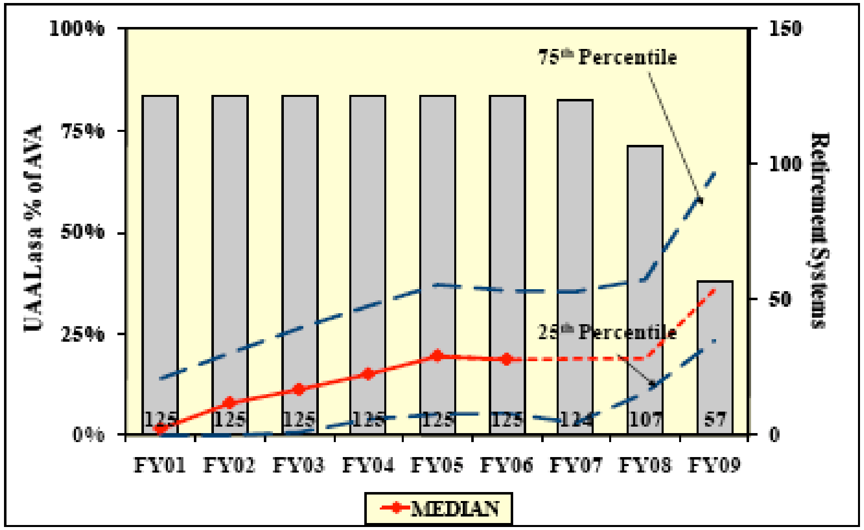
Using the market value of assets to determine funding ratios, 95 of the 107 plans, or 89%, have assets less than liabilities. Four plans have assets less than 50% of liabilities, 35 plans have assets less than 70% of liabilities; and 65 plans have assets less than 80% of liabilities. Using the actuarial value of assets to determine funding ratios, 92 of the 107 plans, or 86%, have assets less than liabilities. Two plans have assets less than 50% of liabilities; 20 plans have assets less than 70% of liabilities; and 49 plans have assets less than 80% of liabilities.

*Source: Wilshire Consulting

I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - **THE** CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

The following chart by Wilshire Consulting shows the median size of the Unfunded Actuarial Accrued Liability (UAAL) relative to the actuarial value of assets during the last eight years for the 125 plans has significantly increased

UAAL as a % of Actuarial Value of Assets by Fiscal Year for 125 Plans



*Source: Wilshire Consulting

I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - **THE** CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

Underfunded Accrued Actuarial Liabilities Per Capita in Chicago

According to The Civic Federation, the total combined unfunded liabilities of the ten local pension funds reviewed by the Federation rose from $3.8 billion in FY2000 to $18.5 billion in FY2008, an increase of $14.7 billion or 387%.

I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - THE CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

The following table produced by the Civic Federation of Chicago shows that FY2000, the unfunded liability per capita for the ten major local government pension funds for which residents of the City of Chicago pay taxes (primarily property taxes and sales taxes) totaled $1,189. The highest per capita unfunded liability was for the Police Fund at $564 per resident of Chicago. The Laborers' and Forest Preserve Funds were both over 100% funded in FY2000 so they showed negative unfunded liabilities per capita. When one includes the five State-sponsored pension funds for which Chicago residents also pay taxes (including income taxes), the unfunded liability per capita in Chicago rises to $2,442.

State and Local Public Pension Funds Unfunded Liabilities Per Capita FY2000*
Total Unfunded Liability Per Capita in the City of Chicago

FUND	FY2000 Unfunded Accrued Actuarial Liability	2000 population	Unfunded liability per capita	Funded Ratio
Chicago Fire[1]	$ 833,853,513	2,896,016	$ 288	59.4%
Chicago Police[1]	$ 1,632,563,097	2,896,016	$ 564	71.1%
Chicago Municipal[1]	$ 367,203,474	2,896,016	$ 127	94.5%
Chicago Laborers[1]	$ (440,057,229)	2,896,016	$ (152)	133.9%
MWRD[1]	$ 156,842,220	5,376,741	$ 29	87.6%
Cook County[1]	$ 363,268,964	5,376,741	$ 68	94.0%
Forest Preserve[1]	$ (6,272,752)	5,376,741	$ (1)	103.7%
CTA[2]	$ 530,761,000	3,700,000	$ 143	77.5%
Chicago Teachers[1]	$ 328,168,774	2,896,016	$ 113	96.7%
Chicago Park District[1]	$ 28,029,013	2,896,016	$ 10	95.7%
SUBTOTAL LOCAL FUNDS	**$ 3,794,360,074**		**$ 1,189**	
Downstate Teachers (TRS)[3]	$ 11,404,991,000	12,419,213	$ 918	68.2%
State University Employees (SURS)[3]	$ 1,615,100,000	12,419,213	$ 130	88.2%
State Employees (SERS)[3]	$ 2,002,087,260	12,419,213	$ 161	81.7%
Judges[3]	$ 448,219,698	12,419,213	$ 36	48.6%
General Assembly[3]	$ 98,891,471	12,419,213	$ 8	41.6%
SUBTOTAL STATE FUNDS	**$ 15,569,289,429**		**$ 1,254**	
TOTAL ALL STATE AND LOCAL FUNDS	**$ 19,363,649,503**		**$ 2,442**	

Note: Includes all major public pension funds for which Chicago residents pay taxes.
[1] Supported by local property taxes (indirectly for Chicago Teachers Fund)
[2] Supported by local sales taxes, real estate transfer tax, and fares
[3] Supported by state sales taxes, income taxes, and other general revenues
Source: FY2000 financial statements of the pension funds
Source for population: U.S. Census Bureau estimates, except CTA is CTA budget book estimate

*Source: The Civic Federation of Chicago – FY2008 Status of Local Pension Reports

I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - **THE** CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

The following table also produced by The Civic Federation of Chicago shows that in FY2008, the unfunded liability per capita for the local funds was $5,821 and the total including State pension funds was $10,037. Of the local funds, the Police Fund had the highest unfunded liability per capita at $1,598, although the Municipal and Teachers' funds also exceeded $1,000 per capita. The Downstate Teachers Fund, however, had an unfunded liability per capita of $2,341 in FY2008.

State and Local Public Pension Funds Unfunded Liabilities Per Capita FY2008
Total Unfunded Liability Per Capita in the City of Chicago

FUND	FY2008 Unfunded Accrued Actuarial Liability	2008 population	Unfunded liability per capita	Funded Ratio (Actuarial)
Chicago Fire[1]	$ 2,022,882,857	2,853,114	$ 709	39.8%
Chicago Police[1]	$ 4,558,826,295	2,853,114	$ 1,598	47.3%
Chicago Municipal[1]	$ 3,936,346,961	2,853,114	$ 1,380	62.9%
Chicago Laborers[1]	$ 258,960,825	2,853,114	$ 91	86.8%
MWRD[1]	$ 640,441,314	5,294,664	$ 121	65.4%
Cook County[1]	$ 3,037,106,552	5,294,664	$ 574	72.6%
Forest Preserve[1]	$ 41,649,951	5,294,664	$ 8	82.5%
CTA[2]	$ 645,885,000	3,800,000	$ 170	75.6%
Chicago Teachers[1]	$ 3,134,053,529	2,853,114	$ 1,098	79.4%
Chicago Park District[1]	$ 208,703,097	2,853,114	$ 73	73.8%
SUBTOTAL LOCAL FUNDS	**$ 18,484,856,381**		**$ 5,821**	
Downstate Teachers (TRS)[3]	$ 30,201,644,000	12,901,563	$ 2,341	56.0%
State University Employees (SURS)[3]	$ 10,331,400,000	12,901,563	$ 801	58.5%
State Employees (SERS)[3]	$ 12,845,913,617	12,901,563	$ 996	46.1%
Judges[3]	$ 844,655,480	12,901,563	$ 65	42.0%
General Assembly[3]	$ 160,374,128	12,901,563	$ 12	32.0%
SUBTOTAL STATE FUNDS	**$ 54,383,987,225**		**$ 4,215**	
TOTAL ALL STATE AND LOCAL FUNDS	**$ 72,868,843,606**		**$ 10,037**	

Note: Includes all major public pension funds for which Chicago residents pay taxes.
[1] Supported by local property taxes (indirectly for Chicago Teachers Fund)
[2] Supported by local sales taxes, real estate transfer tax, and fares
[3] Supported by state sales taxes, income taxes, and other general revenues
Source: FY2008 financial statements of the pension funds
Source for population: U.S. Census Bureau estimates, except CTA is CTA budget book estimate

*Source: The Civic Federation – FY2008 Status of Local Pension Reports

I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - **THE** CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

Illinois New Pension Legislation

While the reforms contained in the legislation do not solve the Illinois or local government pension crises, leaving untouched the benefits of current employees, the legislation creates reduced pension benefits for new 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

I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - **THE** CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

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
- 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

H. 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 1970's	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 1990's and between 2003-2007 has helped investor return and narrowed the underfunding gap and the recent market up tick since mid 2009 has also helped
- However, there are implicit obstacles to solving pension liabilities
- 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.

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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 $2.5 trillion of infrastructure improvement required with the next five years)
- 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
- 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 which is less volatile, more predictable and, if funded currently, far safer
- The transition to DC plan from a DB plan is costly and complicated

I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - **THE** CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

- 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
- 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

I. THE PENSION AND OPEBs CRISIS - THE HARD FACTS AND POSSIBLE SOLUTIONS - **THE** CURRENT STATE OF THE UNDERFUNDING OF PENSIONS AND OPEBS

I. The Recent Vallejo, California Situation Illustrates the Potential for Disruption

- City of Vallejo had unsustainable debt burdens for employee contract costs and pension obligations
- City attempted negotiation with unions and employees in late 2007 and early 2008 without success
- Spring 2008, Vallejo files for bankruptcy and moves to reject employee contracts and to negotiate new lower cost of labor and retirement benefits
- Police, Fire and Electrical Union eventually reached a settlement with the City on labor cost rather than face court rejection and pay as you go funding of labor cost
- Current draft of proposed plan incorporated labor settlement and lower costs as well as payment of pension obligations

II. OPEBs – THE FEAR OF THE UNKNOWN

- Other Post Employment Benefits (healthcare, etc.) are generally a liability for retirees of 10-20 times the current annual benefits

II. OPEBs – THE FEAR OF THE UNKNOWN

A. Other Post Employment Benefits (healthcare, etc.) are generally a liability for retirees of 10-20 times the current annual benefit payments

B. The study and determination of this liability will be dynamic and uncertain given the volatility of health care costs

C. GASB 45 will probably be a two edged sword - helpful disclosure but another previously undisclosed significant liability

D. Bond financing of OPEBs without a total pension/OPEB solution may not be wise

II. OPEBs – THE FEAR OF THE UNKNOWN

IS THERE A SOLUTION?

YES

BUT IT HAS TO BE CRAFTED CAREFULLY

III. 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

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

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

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

B. States that by Specific Constitutional Provisions Prohibit Impairment. In certain States, there are Constitutional prohibitions specifically preventing any reducing or eliminating of pension benefits - State Constitutions prohibit altering (reducing or eliminating) state and local governmental contractual obligations to employees for pension benefits — a "vested" right (See e.g., Illinois, New York, Michigan, etc.)

C. States that Prohibit Impairment on General Basis (General Constitutional Provisions). Some States rely on either the Federal or state constitution language prohibiting the impairment of contract to preclude a reduction in pension rights. These states include Georgia, Indiana, Oklahoma, Rhode Island and West Virginia

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

D. Use of State Statutes to Protect Pension Rights. Some states have enacted statutory provisions which preclude local governments that establish pension and other post-employment benefits from diminishing or impairing those rights (*See e.g. Connecticut, Massachusetts* and *Maine*)

E. Generally the Constitutional or Statutory Provisions Relate to Pension Rights as Compared to OPEBs. Some Courts have extended the protection against reduction in benefits to OPEBs and some have not

1. Accordingly, changes of pension benefits can only be done voluntarily or through Court ordered process
2. Unions and employees generally do not easily agree to changes in pension benefits or OPEB
   - Change voluntarily may only be possible if the situation is desperate and there is imminent loss of jobs and income including benefits

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

3. The analysis states have undertaken in determining whether OPEBs can be modified are instructive

   a. A divided Michigan Supreme in Studier v. Michigan Public School Employees' Retirement Board, 698 N.W. 2d 350 (Mich. 2005) determined that the term "accrued financial benefits" in Michigan Constitution refers only to benefit that increases over time such as retirement benefits and not health insurance benefits which are not protected by state or Federal constitutions

      i. The Michigan State Constitution provides:

      "The accrued financial benefits of each pension plan and retirement system of the State and its political subdivisions shall be a contractual obligation thereof and shall not be diminished or impaired thereby"

      ii. The Michigan decision is in accord with earlier decisions in Colorado, Georgia and Tennessee. For example, Colorado has distinguished between quasi-pension type benefits protected from modification and ancillary benefits such as payments of health insurance premiums

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III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

b. In 2003, Alaska's Supreme Court reached the opposite conclusion, namely, that a health benefit increase is constitutionally protected like retirement plans and cannot be changed and must be honored as a contractual obligation and cannot be reduced or eliminated without consent or just compensation. States that have sided with Alaska are New Jersey, Oklahoma, California and West Virginia

c. Similarly, in *Calabro v. City of Omaha*, 247 Neb. 955, 531 N.W.2d 541 (1995), the Supreme Court of Nebraska considered whether the elimination of a supplemental cost-of-living benefit provided to plaintiffs by the City of Omaha unconstitutionally violated the firefighters' contract rights. The Court first determined that the supplemental cost-of-living benefit constituted a pension in which the plaintiffs obtained a vested, constitutionally protected contractual right because this supplemental benefit was directly related to the pension plan, and in order to receive this benefit, the employee also had to qualify for the pension plan. The Court then determined that the elimination of this supplemental benefit resulted in the unconstitutional impairment of the plaintiffs' contract rights. Cases are now pending in Colorado and Minnesota over the constitutionality of laws that reduced the cost of living increase (*e.g.* Colorado from 3.5% to 2%)

d. By statute, the State of Maine distinguishes between those provisions of the public employee pension protected by the non-impairment clause and those that are not

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

F. The Illinois Approach

- Specific Constitutional Provision Adopted. Illinois adopted a specific constitutional provision in 1970 as part of the Constitutional Convention following the model of New York State and its court decision upholding such a provision
- How Constitutional Prohibition on Impairment Works. Article XIII, section 5, of the Illinois Constitution, which pertains to pension and retirement rights, provides that: "Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." In Felt v. Board of Trustees of the Judges Retirement System, 107 Ill.2d 158, 89 Ill.Dec. 855, 481 N.E.2d 698 (1985): the Supreme Court of Illinois found unconstitutional an amendment to the Illinois Pension Code which changed the salary base for determining pension benefits from the judge's salary on the final day of service to the average salary over the last year in service. The Court found that the amendment violated the constitutional right of judges because it diminished their retirement benefits and impaired their contract rights under § 5 of article XIII of the Illinois Constitution

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III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

- Old Rule Pension Are Gratuities and Changeable; New Rule Pensions Are Vested Rights. Courts interpreting this Constitutional provision "have construed this provision as a guarantee that all public pension benefits are to be determined under a contractual theory rather than being treated as mere gratuities as some pensions had been previously." *Smithberg v. Illinois Municipal Ret. Fund,* 306 Ill.APP.3d 1139, 1142, 716 N.E. 2d 316, 319, 240 Ill.Dec. 183, 186 (3rd Dist. Ill. App. 1999). Thus, under this provision, statutory pension rights to public employees "cannot be altered, modified, or released except in accordance with usual contract principals." *Smithberg,* 306 Ill.App.3d at 1143, 716 N.E.2d at 319, 240 Ill.Dec. at 186. *See also Bosco v. Chicago Transit Auth.,* 164 F.Supp.2d 1040, 1056 (N.D.Ill. 2001) ("The purpose of the provision is essentially to lock in an employee's pension rights as they are stated under the employment contract, or as they exist by statute.")

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

- Pursuant to this pension non-impairment clause, a public employee's rights to a pension is "based on the status of the system when his rights in the system vested, either at the time he entered the system or in 1971 when the 1970 Constitution [providing the non-impairment clause] became effective, whichever is later." *Bosco*, 164 F.Supp.2d at 1055-56. *See also People ex rel. Sklodowski v. State*, 182 Ill.2d 220, 229, 695 N.E.2d 374,3777, 230 Ill.Dec. 884, 887 (Ill. 1998) ("This court has held that the contractual relationship is governed by the actual terms of the Pension Code at the time the employee becomes a member of the pension system."). And once the public employee's rights have vested, a member of the pension system, whether a current employee or a retiree, is contractually protected against a reduction in his or her benefits because such an alternation amounts to a contractual modification of the existing contractual agreement between the Sate and the member. *Kuhlmann v. Bd. Of Trustees of the Police Pension Fund of Maywood,* 106 Ill.App.3d 603, 608, 435 N.E.2d 1307, 1311, 62 Ill.Dec. 335, 339 (1st Dist. Ill. App. 1982)

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G. 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)

(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)

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

H. 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

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

I. The key issue appears to be how can you fund affordable pensions. While State 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 has contributed to the current pension underfunding crisis.

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

J. Pension obligations can, in very extreme circumstances, be “discharged” where necessary to serve an important public purpose

- If the state and local government can not 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

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

- 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 stat 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)

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

K. 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, states 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:
    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, et.) or by referenda of the local electorate

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

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
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 determined
5. Either (a) increase in pension funding (if necessary through tax increases 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

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

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 Function 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 pension and obtaining appropriate pension funding at level that is sustainable while assuring the local government will have funds available to provide essential governmental services

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

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
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

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

L. 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

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III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

M. 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
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

III. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK OR REDUCED?

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

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

IV. WHAT CAN STATE OR LOCAL GOVERNMENTS DO?

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

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

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

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IV. WHAT CAN STATE OR LOCAL GOVERNMENTS DO TO SOLVE A PENSION OR OPEB PROBLEM (WITHOUT RESORTING TO A COURT PROCEEDING)?

- 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

IV. WHAT CAN STATE OR LOCAL GOVERNMENTS DO TO SOLVE A PENSION OR OPEB PROBLEM (WITHOUT RESORTING TO A COURT PROCEEDING)?

- First determine whether the problem is
  - “Unwillingness to Pay” or “Inability to Pay” problem
  - Unwillingness to Pay can be solved
  - 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
  - While both lead to the same result, the Inability to Pay may require more drastic action

A. 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

IV. WHAT CAN STATE OR LOCAL GOVERNMENTS DO TO SOLVE A PENSION OR OPEB PROBLEM (WITHOUT RESORTING TO A COURT PROCEEDING)?

B. 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 and West Virginia 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
2. Review investment policy and returns so that poor investment policies 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

IV. 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

IV. 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

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

IV. 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

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IV. 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

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IV. WHAT CAN STATE OR LOCAL GOVERNMENTS DO TO SOLVE A PENSION OR OPEB PROBLEM (WITHOUT RESORTING TO A COURT PROCEEDING)?

C. The Difference Between DB and DC Plans

- The goal is to terminate DB plans and transition them to DC Plan through full funding to termination of the DB plan and commence a follow-on plan which is DC. History has shown DB plan are costly, unpredictable and subject to market volatility
- DB plan guarantees a specific benefit or income
  - Generally base formula (flat dollar amount multiplied by number of years worked or age or percentage of salary)
  - Market volatility cannot assume investment will always equate to full payment of benefits - there are fluctuations in what should be paid and that can change by how the market or investments perform
  - While DB plan may have years of no need for funding because of the up market, that can switch quickly in a down market and there is the risk

IV. WHAT CAN STATE OR LOCAL GOVERNMENTS DO TO SOLVE A PENSION OR OPEB PROBLEM (WITHOUT RESORTING TO A COURT PROCEEDING)?

- DC Plan provides only a specific payment and no guarantee of a specific benefit or retirement income
  - No formula to determine retirement income
  - Market performance will affect ultimate payment
  - Employee bears risk of investment performance while employer does not get any benefit for investment success
  - Each employee has own account into which contribution will be made and investment income or losses will be added or deducted

IV. WHAT CAN STATE OR LOCAL GOVERNMENTS DO TO SOLVE A PENSION OR OPEB PROBLEM (WITHOUT RESORTING TO A COURT PROCEEDING)?

D. 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

IV. 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

IV. 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

V. FIND A SOLUTION OR RISK AN INEVITABLE MELTDOWN

- Workers Vested Rights and Use of the “Writ of Mandamus”
- Taxpayer Call to Arms - Unjustified Pension Obligations Are Invalid Debt Contrary to Constitutional Limitations or Abuse of Authority or Past Legislative Restrictions
- Stop the Bleeding and Share the Pain

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V. 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
- The Demand to Invalidate Unjustified Pension Obligation. Tax payers 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))

V. 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

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V. 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, necessary use of a Public Pension Funding Authority that will determine objectively the ability to pay from available tax sources, engage government representatives and tax payers 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 Government 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)

VI. 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

VI. 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

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VI. 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

VI. 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 benefit are affordable and what ones, if any, are not?
  - What adjustments to past employment benefits are mandated to avoid a government function meltdown or GFE?
- What is the minimum acceptable funding percentage for funding pension benefit (“Target Percentage”)

VI. 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:

- Whether past employment benefits (pension and OPEB) are affordable and sustainable while paying the cost of essential governmental services?

VI. THE USE OF A PUBLIC PENSION FUNDING AUTHORITY TO SOLVE THE SEVERE PENSION UNDERFUNDING PROBLEM

- What recommendations, if any, for tax increases by the government to provide additional funding?
- Recommend tax increases to fund additional pensions contributions and require the local home rule units legislative body (city council et al.) to consider a tax increase or have a 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
- Determine whether an intercept of state tax revenue should be implemented to pay required benefit
- Determine whether arbitration (voluntary or involuntary) should be engaged in

VI. THE USE OF A PUBLIC PENSION FUNDING AUTHORITY TO SOLVE THE SEVERE PENSION UNDERFUNDING PROBLEM

- Determine whether contributions are necessary from both public employees or employers

- Determine what cost-cutting measure or adjustment of pension benefits are necessary to achieve affordable benefit and allow the continued funding of the cost of essential governmental services

VI. 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
- 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.

VI. 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. Given the quasi-judicial function independent experts with experience in public pension, debt restructuring and related area should be select 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 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

VI. 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 its 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) a government 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.

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VI. 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

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VI. 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. Approve the local government budget
4. 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 and recommend benefit level for employees and retirees at such affordable levels and approve settlements of adjusted benefits or other relief appropriate given the circumstances or (ii) adjudicate necessary modifications to employee contract and approve arbitration decision

VI. THE USE OF A PUBLIC PENSION FUNDING AUTHORITY TO SOLVE THE SEVERE PENSION UNDERFUNDING PROBLEM

5. Suspend tax limitations or caps and mandate tax increase votes or referenda to provide adequate funding of past employment obligations
6. Increase pension contributions by employer and employees so that the ARC is paid annually and all past employment benefits are adequately funded
7. 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
8. Transfer the local pension plan to an established statewide plan structured to ensure adequate funding and state intercept of tax authority
9. 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-package plan of debt adjustment

VI. 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 government function meltdown. The stigma of Chapter 9 and its harsh consequences can be avoided by use of the Authority. The political or short sighted 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

VII. CAN BANKRUPTCY OR COURT PROCEEDINGS BE THE SOLUTION?

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

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VII. 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

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

VII. CAN THE UNDERFUNDING OF PENSIONS FOR STATE OR LOCAL GOVERNMENTS BE ADDRESSED IN COURT PROCEEDINGS?

3. <u>To Balance Rights and Interests</u>. Some Courts have attempted to balance the interest and benefits in authorizing change to Pension Plans

4. <u>These Principles in Practice</u>. 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 P2d 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 NE2d 1095 (Mass. 2000)

VII. 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 SE2d 130 (W.Va. 1998)

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VII. 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

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VII. CAN THE UNDERFUNDING OF PENSIONS FOR STATE OR LOCAL GOVERNMENTS BE ADDRESSED IN COURT PROCEEDINGS?

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
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

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VIII. GENERAL ANALYSIS OF CHAPTER 9

- Debtor Needs to Be a Municipality
- Need State Authorization to File (Specific Statutory Authorization)
- Only Deals with Debt Adjustment and Not with Politics, Governmental Affairs or Revenues

VIII. GENERAL ANALYSIS OF CHAPTER 9

A. *Who Can Be a Debtor under Chapter 9?*

1. The requirements are found in Section 109(c) of the Bankruptcy Code

   – A Debtor must be:

     - An entity that is municipality
     - Specifically authorized (under State Law) to be a Debtor
     - Insolvent
     - Willing to effect a plan to adjust its debts

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VIII. GENERAL ANALYSIS OF CHAPTER 9

2. And meet one of the following requirements:

   - The Debtor has obtained the agreement of creditors holding at least a majority in the amount of claims of each class that the Debtor intends to impair through its plan
   - The Debtor has negotiated in good faith but failed to obtain the agreement of creditors holding at least a majority in the amount of claims of each class that the Debtor intends to impair under its plan
   - The Debtor is unable to negotiate with its creditors because such efforts are impracticable or
   - The Debtor must reasonably believe that a creditor may attempt to obtain a preference

VIII. GENERAL ANALYSIS OF CHAPTER 9

B. *What is a Municipality?*

1. Under 11 U.S.C. §101(15):

   An “entity” includes a person, estate, trust, governmental unit, and United States Trustee

2. Under 11 U.S.C. §101(27):

   A “governmental unit” means United States, State, Commonwealth, District, Territory, municipality, foreign state, department, agency, or instrumentality of the United States (but not a United States trustee while serving as a Trustee), a State, a Commonwealth, a District, a Territory, a <u>municipality</u>, or a foreign state or other foreign or domestic government

3. Under 11 U.S.C. §101(40):

   A “municipality” means political subdivision or public agency or instrumentality of a state

VIII. GENERAL ANALYSIS OF CHAPTER 9

C. *How Does a Municipality Become a Debtor?*

1. Only the municipality can initiate the proceeding in accordance with the requirements of the state enabling legislation

2. There can be no involuntary Chapter 9 proceeding. Not only are involuntary proceedings constitutionally prohibited, but there is no statutory basis for an involuntary action. (Only Section 301 of the Bankruptcy Code providing for voluntary cases is incorporated into Chapter 9)

VIII. GENERAL ANALYSIS OF CHAPTER 9

3. In *In re County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995), the court held that the Orange County Investment Pool ("OCIP"), as an instrumentality of the County of Orange, was not an instrumentality of a state and hence not a municipality. (Some have criticized this decision suggesting the language "of a state" means the instrumentality must be subject to control by a state or municipal authority and that Congress intended the definition of "municipality" to be expansive.)

4. While the characterization of certain public/private partnerships may be open to question, most special districts that are formed under state statutes to perform certain public services or provide public utilities should qualify as "municipalities"

VIII. GENERAL ANALYSIS OF CHAPTER 9

D. *Specifically Authorized*

- The Bankruptcy Reform Act of 1994 made it clear that, to be a Chapter 9 Debtor, the municipality must be specifically authorized in its capacity as a Debtor or by name
- Given the ruling in the Orange County case, that the OCIP was not specifically authorized since the California statute did not refer to an investment fund, current wisdom is that, unless the state statute makes it clear, risk that municipality may not be an eligible debtor

VIII. GENERAL ANALYSIS OF CHAPTER 9

Who Can File?

- 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. Sixteen States have Statutory Provisions in which the State specifically authorizes filing (AL, AZ, AR, CA, FL, ID, KY, MN, MT, NE, NY, OK, SC, TX, WA), another seven States authorize a filing conditioned on a further act of the State, an Elected Official or State entity (CN, LA, MI, NJ, NC, OH, PA) Three states (CO, OR and IL) grant limited authorization, two states prohibit filing (GA) but one of them (IO) has an exception to the prohibition. The remaining 22 are either unclear or do not have specific authorization
  - Insolvent
  - Willing to effectuate a plan
  - 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
  - California has recently passed legislation that is subject to the governor’s signature that could limit a municipality’s authority to file to requiring the approval of the California Debt Advisory Commission.

VIII. GENERAL ANALYSIS OF CHAPTER 9

General Analysis of State Specific Authorization for Municipalities to File a Chapter 9 Case

The following are statutory provisions in which states have authorized Chapter 9 filings for certain governmental entities

<u>16 States that specifically authorize municipal bankruptcies:</u>

Ala. Code 1975 § 11-81-3
Ariz. Rev. Stat. Ann. § 35-603
Ark. Code Ann. § 14-74-103
Cal. Gov't Code § 53760
Fla. Stat. Ann. § 218.01
Idaho Code Ann. § 67-3903
Ky. Rev. Stat Ann. § 66.400
Minn. Stat. Ann. § 471.831
Mo. Ann. Stat. § 427.100
Mont. Code Ann. § 7-7-132
Neb. Rev. St. § 13-402
N.Y. Local Finance Law § 85.80
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

<u>7 States that *conditionally* authorize municipal bankruptcies</u>:

Conn. Gen. Stat. Ann. § 7-566
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
Ohio Rev. Code Ann. § 133.36
53 Pa. Cons. Stat. Ann. § 11701.261

<u>3 States with limited authorization</u>

- 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))

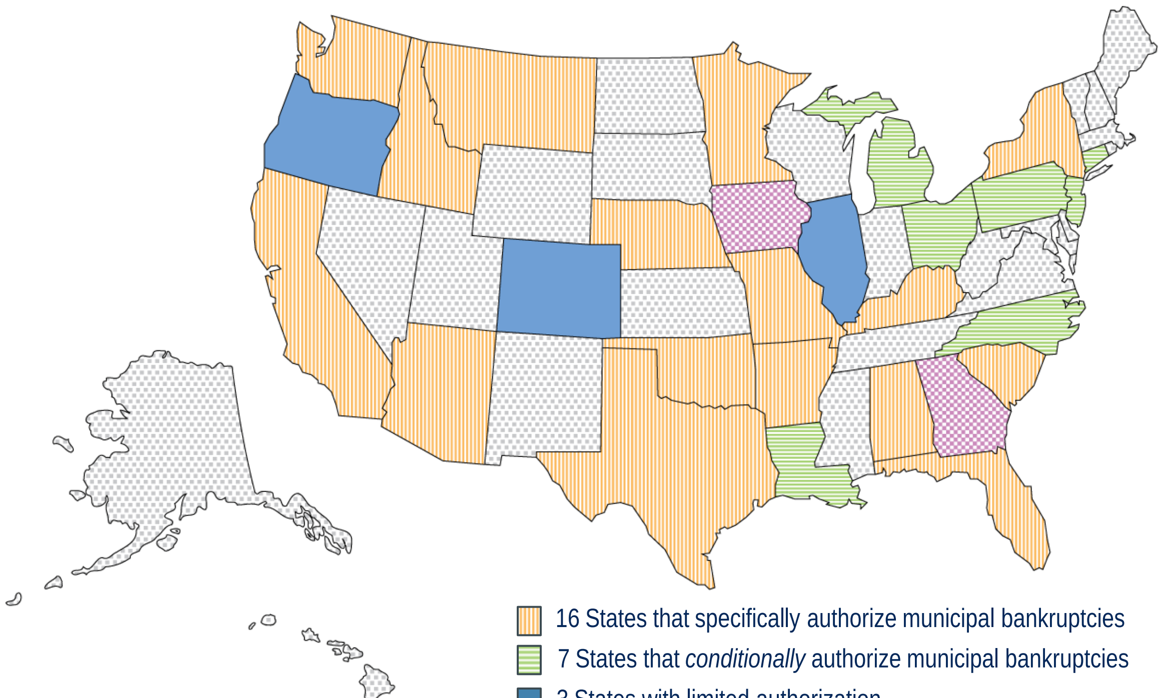
<u>2 States prohibit filing but one has an Exception</u>

- 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)

The 22 Remaining States are either unclear or do not have specific authorization

VIII. GENERAL ANALYSIS OF CHAPTER 9

General Analysis of State Specific Authorization for Municipalities to File a Chapter 9 Case



- 16 States that specifically authorize municipal bankruptcies
- 7 States that *conditionally* authorize municipal bankruptcies
- 3 States with limited authorization
- 2 States prohibit filing, but one has an exception (Iowa)
- Remaining 22 States are either unclear or do not have specific authorization so there is no specific authorization

VIII. GENERAL ANALYSIS OF CHAPTER 9

How Does a Municipality Become a Debtor?

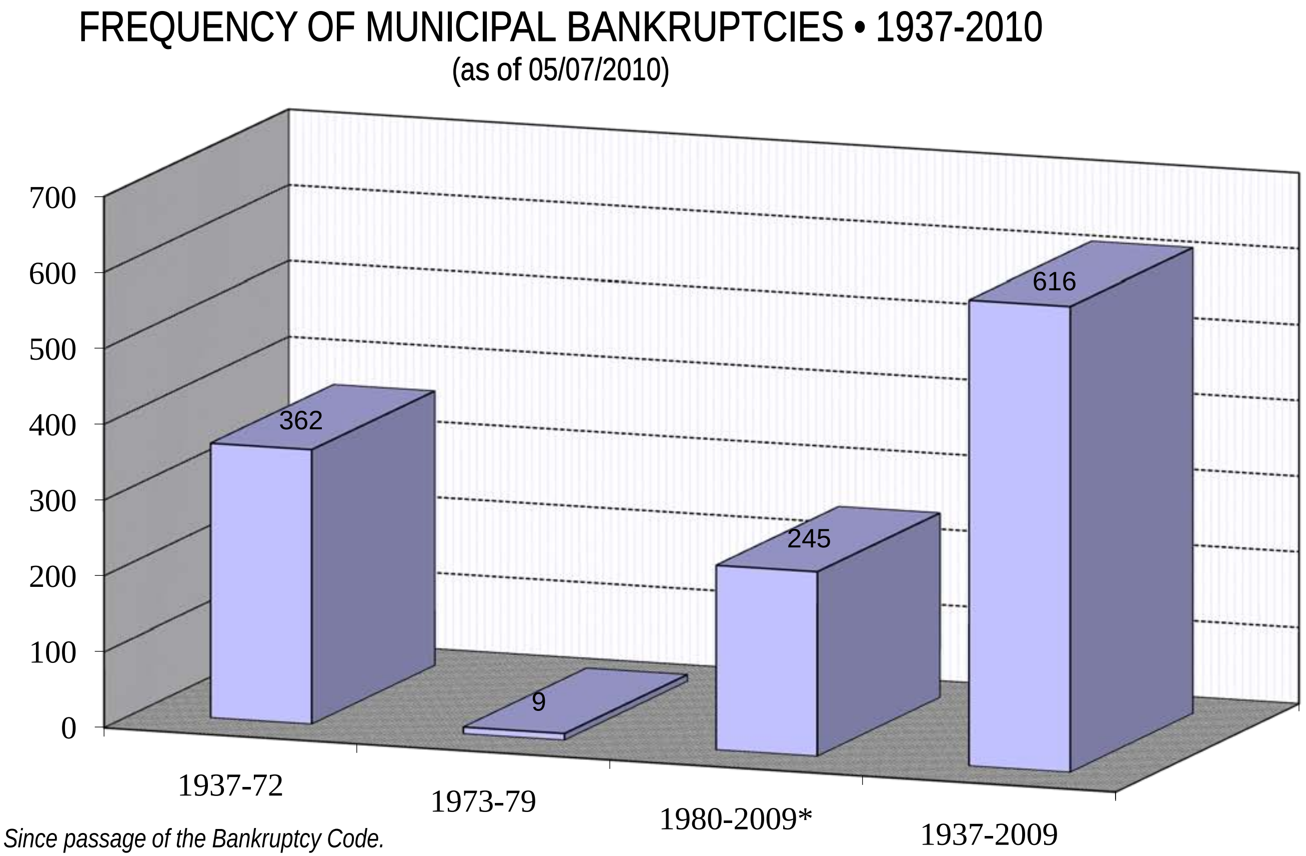
- Only the municipality can initiate the proceeding in accordance with the requirements of the state enabling legislation.
- There can be no involuntary Chapter 9 proceeding. Not only are involuntary proceedings constitutionally prohibited, but there is no statutory basis for an involuntary action. (Only Section 301 of the Bankruptcy Code providing for voluntary cases is incorporated into Chapter 9.)

VIII. GENERAL ANALYSIS OF CHAPTER 9

E. *Insolvency*

1. As of the petition date, must meet the test of 11 U.S.C. §101(32) - unable to pay debts as they become due
2. The Bridgeport, Connecticut Chapter 9 was dismissed because evidence only supported finding that it might be unable to meet its debt obligations in the next year. *In re City of Bridgeport*, 129 B.R. 332 (Bankr. Conn. 1991)
3. No requirement that future tax increase be included in equation but municipality cannot deliberately budget itself into insolvency
4. Determination of solvency without substantial regard to either future potential revenues or shortfalls

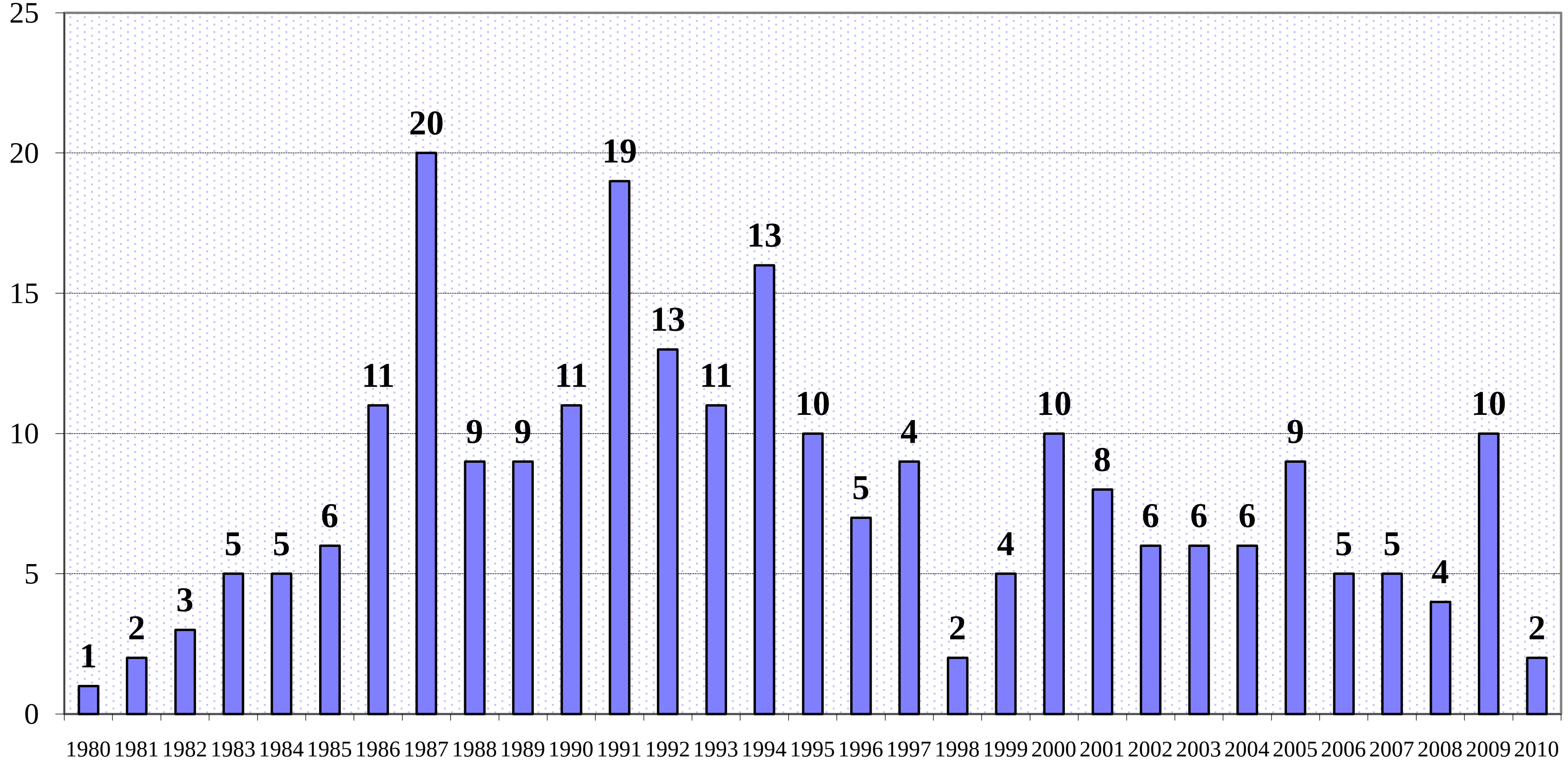
VIII. GENERAL ANALYSIS OF CHAPTER 9



** Since passage of the Bankruptcy Code.*

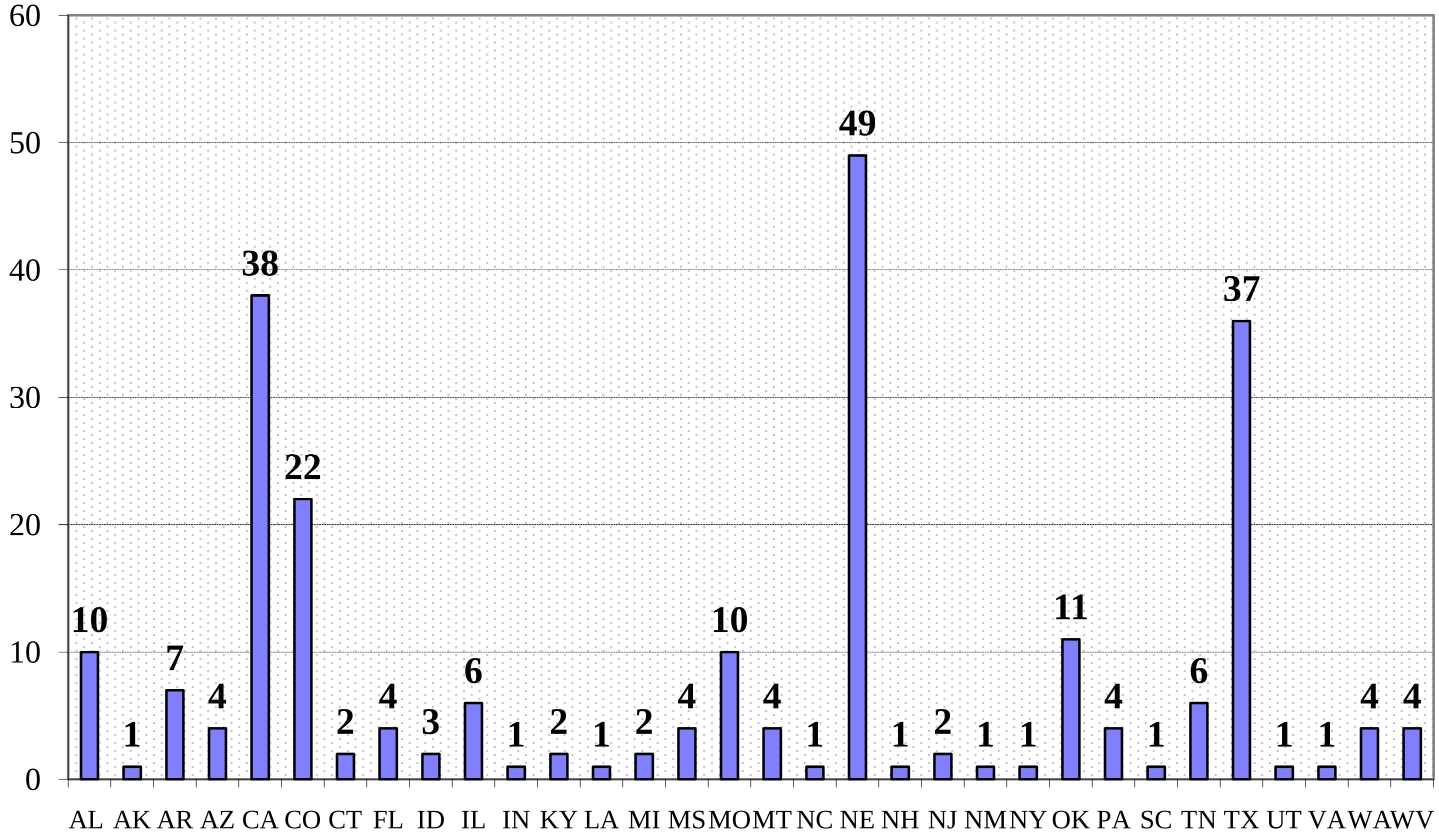
VIII. GENERAL ANALYSIS OF CHAPTER 9

CHAPTER 9 FILINGS BY YEAR • 1980-2010
(as of 05/07/2010)

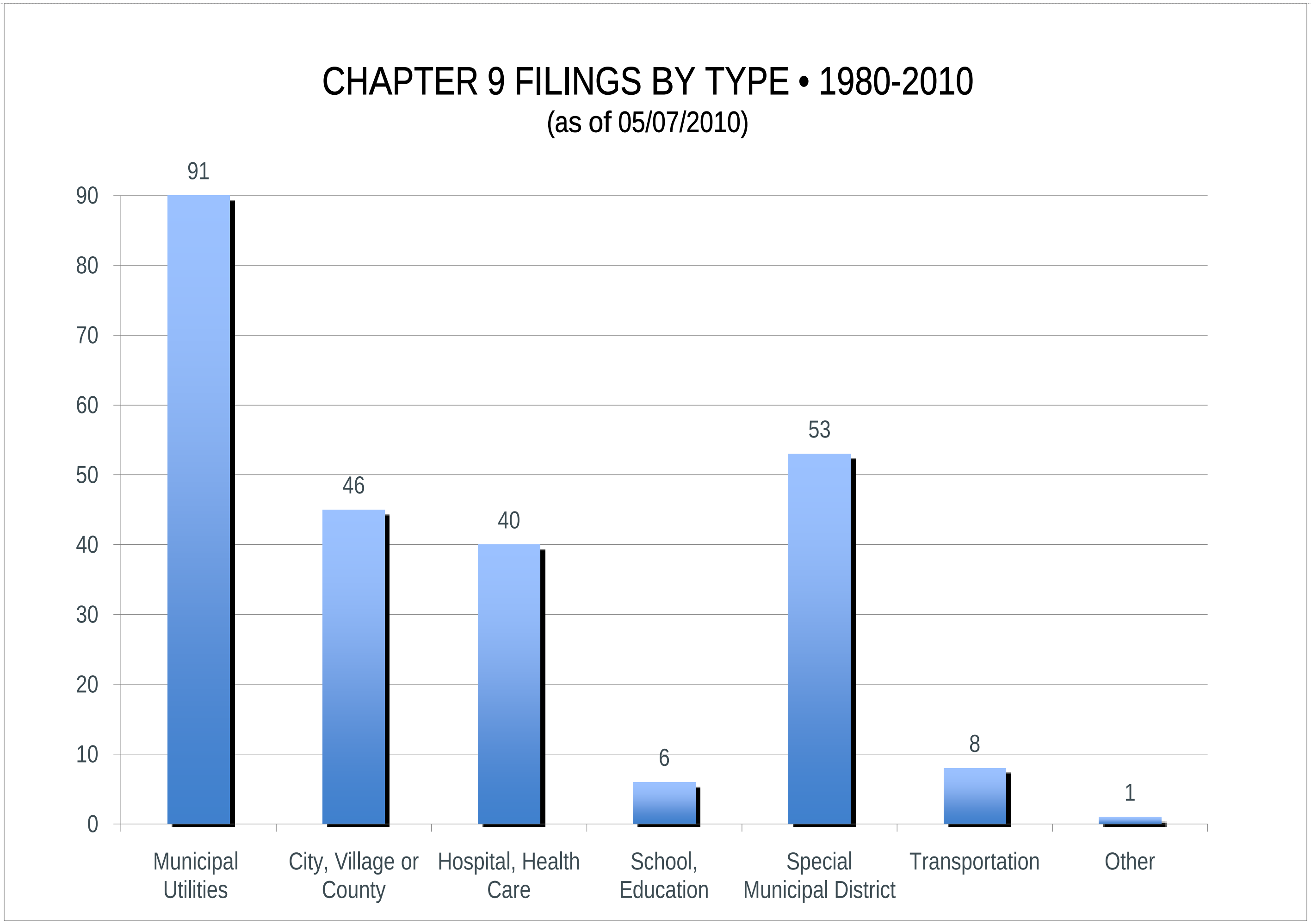


VIII. GENERAL ANALYSIS OF CHAPTER 9

CHAPTER 9 FILINGS BY STATE • 1980-2010
(as of 05/07/2010)



VIII. GENERAL ANALYSIS OF CHAPTER 9



IX. 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

IX. TREATMENT OF PENSION AND OPEBs IN A CHAPTER 9 PROCEEDING

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 616 Chapter 9 proceedings since 1937 (312 between 1937-1972, 9 between 1973-1979, 245 between 1980-2010 (May))

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

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IX. 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), $11,725 per employee priority for amounts earned but not made within 180 days of the filing of bankruptcy

IX. TREATMENT OF PENSION AND OPEB LIABILITIES IN CHAPTER 9 PROCEEDINGS

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, 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

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 is not part of Chapter 9 authorization

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IX. TREATMENT OF PENSION AND OPEB LIABILITIES IN CHAPTER 9 PROCEEDINGS

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 (pre-petition) 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

IX. 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

IX. TREATMENT OF PENSION AND OPEB LIABILITIES IN CHAPTER 11 PROCEEDINGS

- $11,725* 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)

- 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)

X. TREATMENT OF PENSION BENEFITS AND OPEBs 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

X. TREATMENT OF PENSION BENEFITS AND OPEBs 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 $11,725 per employee priority for wages, sick leave, pension and health care payments earned but not paid during 180 days prior to filing

X. TREATMENT OF PENSION BENEFITS AND OPEBs IN CHAPTER 11 PROCEEDINGS

B. 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

X. TREATMENT OF PENSION BENEFITS AND OPEBs 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

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

X. TREATMENT OF PENSION BENEFITS AND OPEBs IN CHAPTER 11 PROCEEDINGS

C. Overview of PBGC Claim in Bankruptcy

1. PBGC has two major and somewhat overlapping claims against bankruptcy sponsors of pension plans, namely:
   - "<u>Plan Asset Insufficiency</u>" claim arising on termination of a pension 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)
   - "<u>Unpaid Funding Contributions</u>" 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)

X. TREATMENT OF PENSION BENEFITS AND OPEBs 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 pre-petition (and the PBGC's lien is not perfected), PBGC asserts an eighth priority under §507(a)(9) 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

X. TREATMENT OF PENSION BENEFITS AND OPEBs IN CHAPTER 11 PROCEEDINGS

- No tax priority for PBGC claim. Generally, Court's have refused to grant tax priority for any of PBGC claim since no ERISA claims are included in Section 507 (not a tax due and owing), no lien ripening into perfected lien given automatic stay prevents perfection of the lien

- No administrative priority for PBGC claims. Generally it is a claim for pre-petition labor service so it should be treated as general unsecured claim and there is no post-petition benefit for the pre-petition services. However, if the claim relates to post-petition services, then administrative priority may be granted

X. TREATMENT OF PENSION BENEFITS AND OPEBs IN CHAPTER 11 PROCEEDINGS: THE VALLEJO EXPERIENCE

- 05/23/2008 – Vallejo Files Bankruptcy Petition
- 09/19/2008 – Motion for Leave to Appeal Filed in Bankruptcy Case
- 09/19/2008 – Motion for Leave to Appeal Bankruptcy Ruling Granted
- 01/27/2009 – City of Vallejo & Police Officers Association Reach Agreement on Labor Contract
- 02/10/2009 – City of Vallejo & CAMP Association Reach Agreement on Labor Contract
- 03/13/2009 – Memorandum Regarding Rejection of Collective Bargaining Agreements (CBAs)
- 04/27/2009 – Judge Rules that Collective Bargaining Agreements
- 06/26/2009 – Bankruptcy Appellate Panel Affirms Bankruptcy Ruling
- 08/07/2009 – Labor Withdraws Appeal to Ninth Circuit
- 08/27/2009 – Bankruptcy Court Approves Agreement between the City and IAFF Regarding Rejection of the Collective Bargaining Agreement with IBEW
- 09/01/2009 – Bankruptcy Court Grants City's Motion for Approval of Rejection of Collective Bargaining Agreement with IBEW
- 09/25/2009 – City of Vallejo Begins Process of Negotiating New Contract with IBEW
- 10/26/2009 – Bankruptcy Court Denies Retirees Committee's Motion to Dismiss Case or Establish a Deadline for City to File Plan of Adjustment
- 11/18/2009 – City of Vallejo and the International Brotherhood of Electrical Workers Declare Impasse in Labor Contract Negotiations
- 03/11/2010 – Committee of Retirees sues City to Restore Health Care Benefits

XI. 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