

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

The Current State of Credit

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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

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

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

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

- A. State and local government workers are approximately 12% of the nation's workforce — 16 million employees
- B. While available cash to pay for employee benefits was decreasing, local and state governments sought to meet demand for services by adding more workers faster than other sectors
 - 1. Since 1970, state and local employees have increased by over 60% and have increased more than any other percentage of overall government employees (federal, state and local) from 77.8% to 85.6%

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

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

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

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

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

- C. Meanwhile, demographics and actuarial assumptions have changed and there has been increased attention focused on the ability of state and local governments to pay the accrued costs of benefits for the expanding number of government employees
- D. In the United States, the unfunded pension liability of state and local governments is intended to exceed to \$1 trillion with OPEBs ranging from \$300-700 billion. Some economists have suggested that given a realistic rate of return for investments as compared to the “unrealistic” rate of return on investments projected by State and Local Pension Fund, the real amount of underfunding is closer to \$3 Trillion. The cost of unfunded health benefits promised to retirees could push the number even higher
- E. At the same time, the debt of state and local governments has almost doubled in the last ten years from \$1.197 trillion in 2000 to \$2.362 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

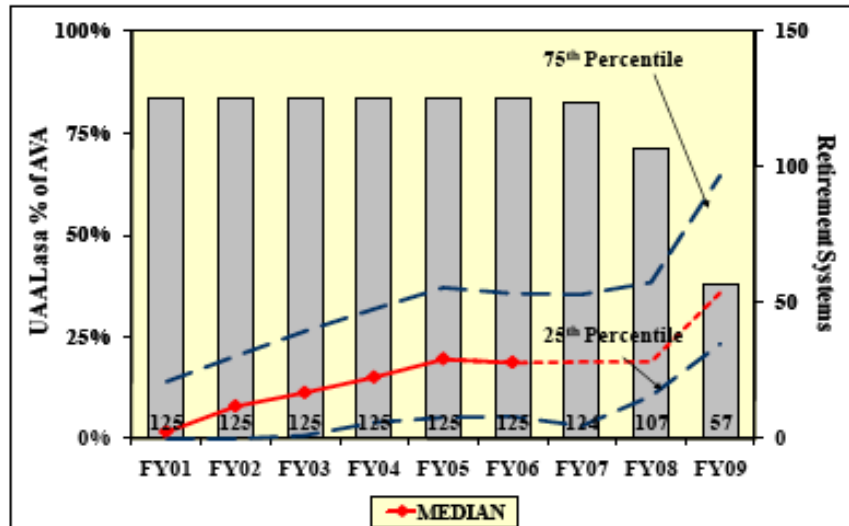
Wilshire Consulting has released its 2010 Report on State Retirement Systems: Funding Levels and Asset Allocation. The study includes 125 state retirement systems and concludes the following:

- 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%

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

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
- Minnesota, South Dakota and Colorado have passed legislation to adjust (i) retirement age, and (ii) pension benefits (lowering or eliminating increases in pension benefits or increasing employer/employee contributions) to realistic and affordable levels and those pieces of legislation are being challenged in the courts as to impairing pension and retirement rights

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

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

The average funding ratio has grown and declined over time

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

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

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

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

- State and local legislatures listen and respond to employee unions and increase benefits without providing corresponding sources of funding
- The ever increasing demand for infrastructure improvements and expanded public safety services have more than strained state and local budgets (estimated \$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 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

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

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

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

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

CATEGORIZATION OF CERTAIN STATE PUBLIC EMPLOYEE PENSION PROVISIONS

Specific state constitution prohibiting impairment of public employee pensions	General constitutional prohibition against impairment of contracts (applicability to pensions depends on whether the courts view pensions as contractual obligations; also, states that do not have their own Contract Clause oftentimes rely on the Contract Clause of the U.S. Constitution):	State statute or case law prohibiting impairment of public employee pensions
Alaska, Hawaii, Illinois, Michigan, New Hampshire, New York	Arkansas, Georgia, Indiana, Nebraska, New Jersey, Oklahoma, Rhode Island, Tennessee, West Virginia	Alabama, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, Wyoming

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

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)

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

The Non-Impairment Laws Are Not All-Encompassing and Have Been Held Not to Reach:

- benefits that accrue in the future
- reduction in mandatory retirement age
- reduction in hours or salary
- loss of benefits for non-compliance with the plan
- dismissal of public employee

even though such may indirectly affect the pension benefits received

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

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

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

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

- If the state and local government cannot fund pension obligations since there are not sufficient tax revenues to pay for essential government services and pay pension obligations
- This is an inability (insolvency) not an unwillingness to pay
- Pension obligations cannot be enforced if to do so would frustrate the essential purpose of the governmental body and sacrifice the required services it must provide
- The U.S. Supreme Court has supported the ability of the state to set up municipal receiverships or other quasi-judicial mechanism to discharge obligations that cannot be paid given the dire financial condition and the need to continue governmental services for the financially embarrassed governmental body

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

- In the case of *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942), the New Jersey Municipal Finance Act provided that a state agency could place a bankrupt local government into receivership. Under the law, similar to a Plan of Adjustment for a Chapter 9 municipal bankruptcy action, the interested parties could devise a plan that would be binding on nonconsenting creditors if a state court decided that the municipality could not otherwise pay its creditors and the plan was in the best interest of all creditors. *Id.* at 504. After certain bondholders dissented, the court determined that the plan helped the city meet its obligations more effectively. *Id.* **“The necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city’s debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired.”** *Id.* at 511. The court then found that the plan protected creditors and was not in violation of the Contract Clause. *Id.* at 513. *See also U.S. Trust v. New Jersey*, 431 U.S. 1, 25-28 (1997)

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

The Public Pension Authority Solution?

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

- Under those circumstances, the federal government could create a Special Commission court or authority, or a state can choose to:
 - Establish fact-finding and determining boards, commissions or authorities (“Public Pension Funding Authority”) that can determine the critical facts necessary for funding or restructuring unfunded pensions based on the circumstances such as:
 1. The ability and willingness to increase taxes and to fund pensions can be determined by the Public Pension Funding Authority with recommendations to local government home rule legislative boards (city council, etc.) or by referenda of the local electorate

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

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

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

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

II. CAN PENSION BENEFITS AND OPEBs BE ROLLED BACK, REDUCED OR CHANGED?

8. The Public Pension Funding Authority will provide transparency and independent fact determination and can recommend increased pension funding or state intercept of taxes otherwise available to the local governmental body to be used for funding pension payments so that they are the actuarially-required payment or, if necessary, determine there must be a restructuring in order to avoid a breakdown of essential governmental services and a GFE. In recommending a restructuring, the pension authority can determine what is affordable and sustainable and recommend changes to the local governmental body and workers or it can be empowered to require such restructuring, if necessary, through a pre-packaged plan in Chapter 9 filing
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. WHAT CAN STATE OR LOCAL GOVERNMENTS DO TO SOLVE A PENSION OR OPEB PROBLEM (WITHOUT RESORTING TO A COURT PROCEEDING)?

The beginnings of movement toward a Public Pension Authority Model:

There are some actions that state or local governments can take to attempt to solve pension problem as part of or prior to use of a public pension funding authority and outside of a Chapter 9 or court proceeding (states such as Arizona, California, Illinois, New York, Oregon 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 are identified and changed before it is too late. Arbitrary rules of valuation or investment can contribute to underfunding. Market volatility can provide false comfort as compared to realistic valuation of assets with adjustment for market cycle. Be careful to avoid if possible losses not reflected in valuations and report accurately any deferral of gains

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

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

IV. A SOLUTION IS REQUIRED TO AVOID THE INEVITABLE MELTDOWN

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

IV. A SOLUTION IS REQUIRED TO AVOID THE INEVITABLE MELTDOWN

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

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

- Likewise, given the Pension Underfunding Crisis, Public Pension Funding Authorities can provide a supervised forum to assist in determining critical issues such as:
 - What contribution increases are necessary by both public employers and employees?
 - Can taxes be raised to fund pensions?
 - Are intercepts of state revenue necessary to provide a source of funding?
 - Can the annual Actuarially Required Contribution (“ARC”) for pension be made or is it unreasonable, unaffordable and not sustainable?
 - Will continued funding of ARC cause the government to be unable to fund the costs of essential governmental services?

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

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

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

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?

V. 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?
- What recommendation of reduction in pension or OPEB benefits are mandated in order to prevent a governmental functions emergency or meltdown?
- Recommend tax increases to fund additional pensions contributions and require the local home rule unit's legislative body (city council et al.) to consider a tax increase or have non-home rule governments have a referenda over a tax increase with full information available on the Authority's determination of the recommendation of tax increases, the affordability of current and future pension costs and whether any pension costs adjustments are necessary
- Determine whether an intercept of state tax revenue should be implemented to pay required benefits

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

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

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

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

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

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

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

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

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

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

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

1. Recommend tax increase or requiring a referenda on tax increases
2. Intercept state taxes in order to pay ARC and other past employment benefits
3. Recommend reductions in pension or OPEB benefits to prevent governmental functions emergency or meltdown
4. Approve the local government budget
5. Require mandatory arbitration which could include (i) making findings and determinations as to the level of employee benefits and whether they are sustainable and affordable by the government recommending benefit level for employees and retirees at such affordable levels and approving settlements of adjusted benefits or other relief appropriate given the circumstances or (ii) adjudicating necessary modifications to employee contracts and approving arbitration decisions

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

6. Suspend tax limitations or caps and mandate tax increase votes or referenda to provide adequate funding of past employment obligations
7. Increase pension contributions by employer and employees so that the ARC is paid annually and all past employment benefits are adequately funded
8. Provide ability to issue bonds to cover a portion of pension or OPEB but only if tied to the enactment of significant pension/OPEB reforms that are determined to be a complete resolution of the problem
9. Transfer the local pension plan to an established statewide plan structured to ensure adequate funding and state intercept of tax authority
10. Authorize the local government to file for municipal debt adjustment (Chapter 9 of Federal Bankruptcy Code) using the determinations of the Authority as the basis for a pre-packaged plan of debt adjustment

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

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

VI. 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 a municipality
 - Specifically authorized (under state law) to be a Debtor
 - Insolvent
 - Willing to effect a plan to adjust its debts

VI. 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

VI. 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 municipality, or a foreign state or other foreign or domestic government

3. Under 11 U.S.C. §101(40):

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

VI. 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)

VI. 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 that 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”

VI. GENERAL ANALYSIS OF CHAPTER 9

- 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. Fifteen States have Statutory Provisions in which the State specifically authorizes filing (AL, AZ, AR, CA, ID, KY, MN, MO, MT, NE, NY, OK, SC, TX, WA), another nine States authorize a filing conditioned on a further act of the State, an Elected Official or State entity (CT, FL, LA, MI, NJ, NC, OH, PA, RI) Three states (CO, OR and IL) grant limited authorization, two states prohibit filing (GA) but one of them (IA) has an exception to the prohibition. The remaining 21 are either unclear or do not have specific authorization;
 - Insolvent;
 - Willing to effectuate a plan; and
 - Either have obtained the agreement of creditors holding majority amount of the claim of each class that the municipality intends to impair or have attempted to negotiate in good faith, but was unable to do so or it was impractical to negotiate with creditors or a creditor is attempting to obtain a preference

VI. GENERAL ANALYSIS OF CHAPTER 9

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

15 States that specifically authorize municipal bankruptcies:

Ala. Code 1975 § 11-81-3
Ariz. Rev. Stat. Ann. § 35-603
Ark. Code Ann. § 14-74-103
Cal. Gov't Code § 53760
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

9 States that *conditionally* authorize municipal bankruptcies:

Conn. Gen. Stat. Ann. § 7-566
Fla. Stat. Ann. § 218.01
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
R.I. Gen. Laws §45-9-7

3 States with limited authorization

▪Colorado has enacted legislation specifically authorizing its beleaguered special taxing districts to file a petition under Chapter 9. Section 32-1-1403 of the Colorado revised statutes states that “any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law and to take any and all action necessary or proper to carry out the plan filed with said petition...” (CRS § 37-32-102 (Drainage & Irrigation District))

▪Oregon permits Irrigation and Drainage Districts to file (Or. Rev. Stat. § 548.705)

▪Illinois – specific authorization solely for the Illinois Power Agency (20 Ill Comp. Stat. Ann. 3855/1-20(b)(15)). The Local Government Financing and Supervision Act permits that commission to recommend that the Legislature authorize a filing but it is not specific authorization (20 Ill. Comp. Stat. Ann. 320/9(b)(4))

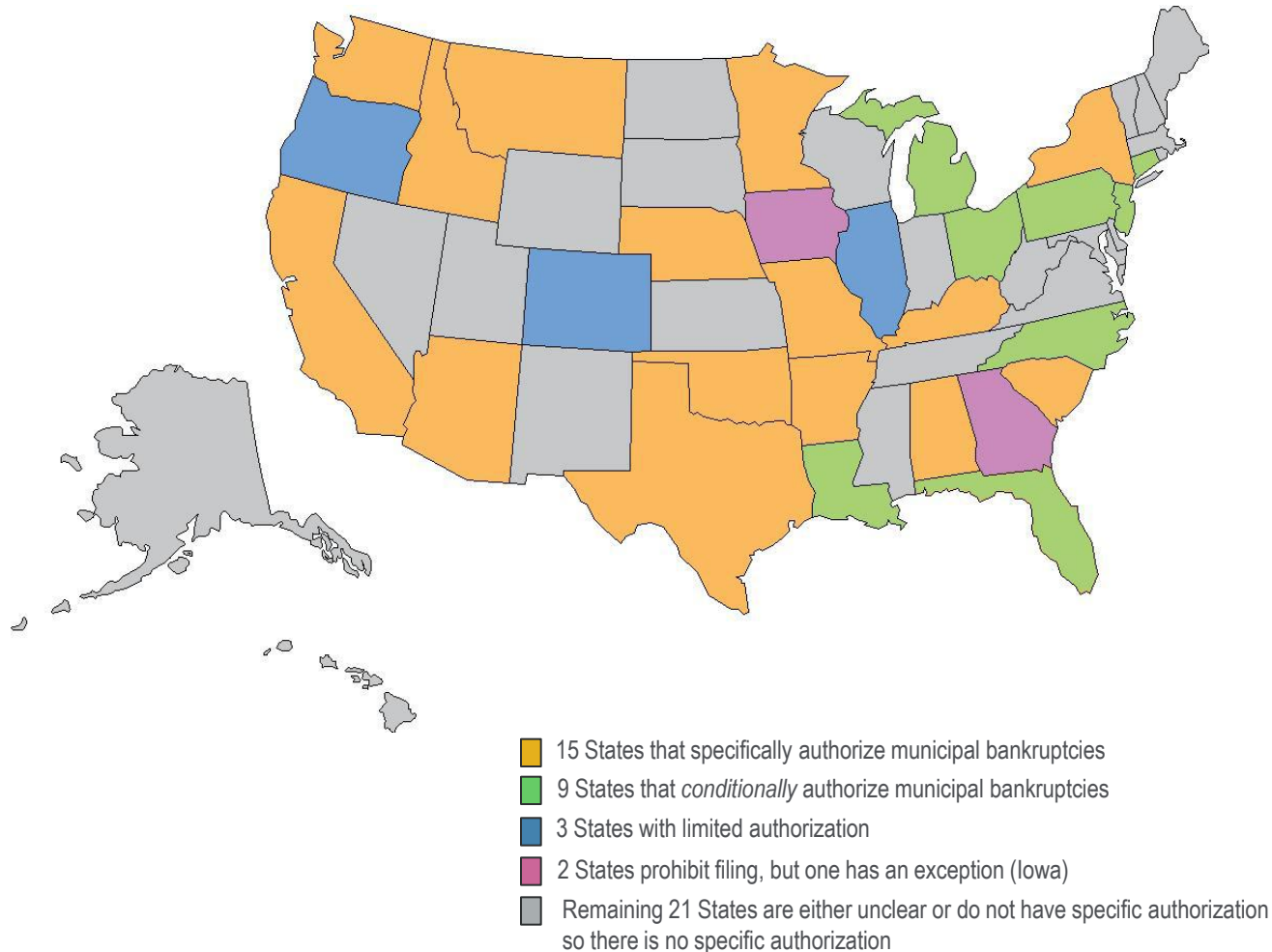
2 States prohibit filing but one has an Exception

▪Iowa generally prohibits filing Chapter 9 (Ia. Code Ann. § 76.16) but allows filing for insolvency caused by debt involuntarily incurred not covered by insurance proceeds (Ia. Code Ann. § 76.16A)

▪Georgia prohibits the filing of Chapter 9 Bankruptcy (Ga. Code Ann. § 36-80-5)

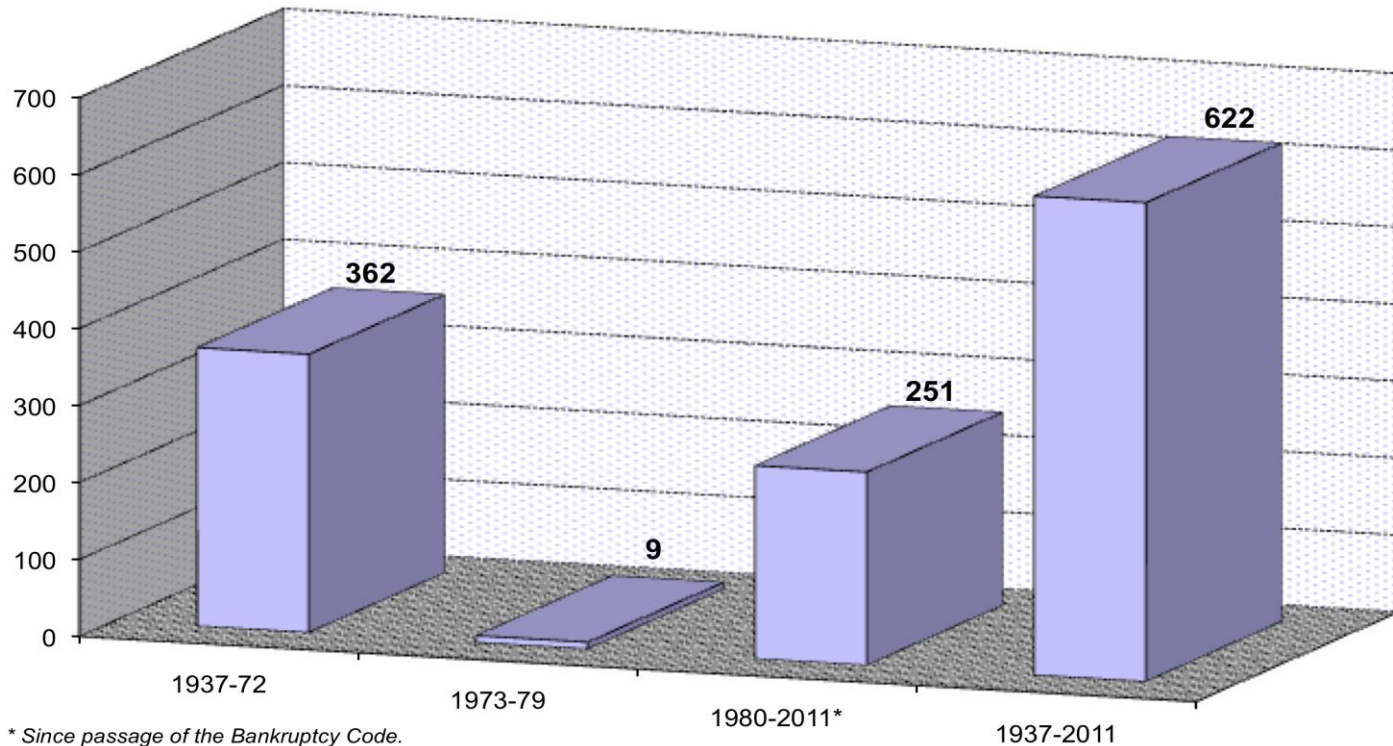
The 21 Remaining States are either unclear or do not have specific authorization.

VI. GENERAL ANALYSIS OF CHAPTER 9



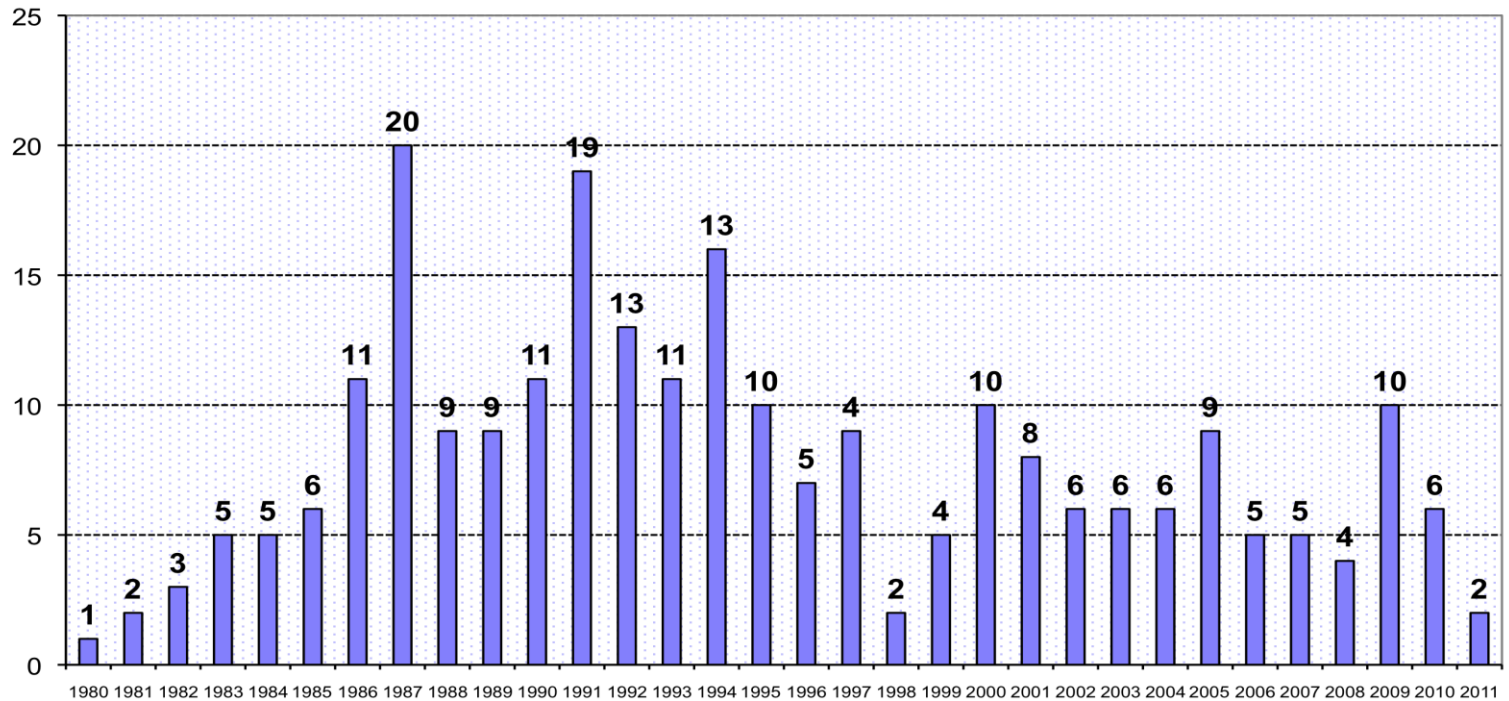
VI. GENERAL ANALYSIS OF CHAPTER 9

FREQUENCY OF MUNICIPAL BANKRUPTCIES • 1937-2011
(as of 03/23/2011)



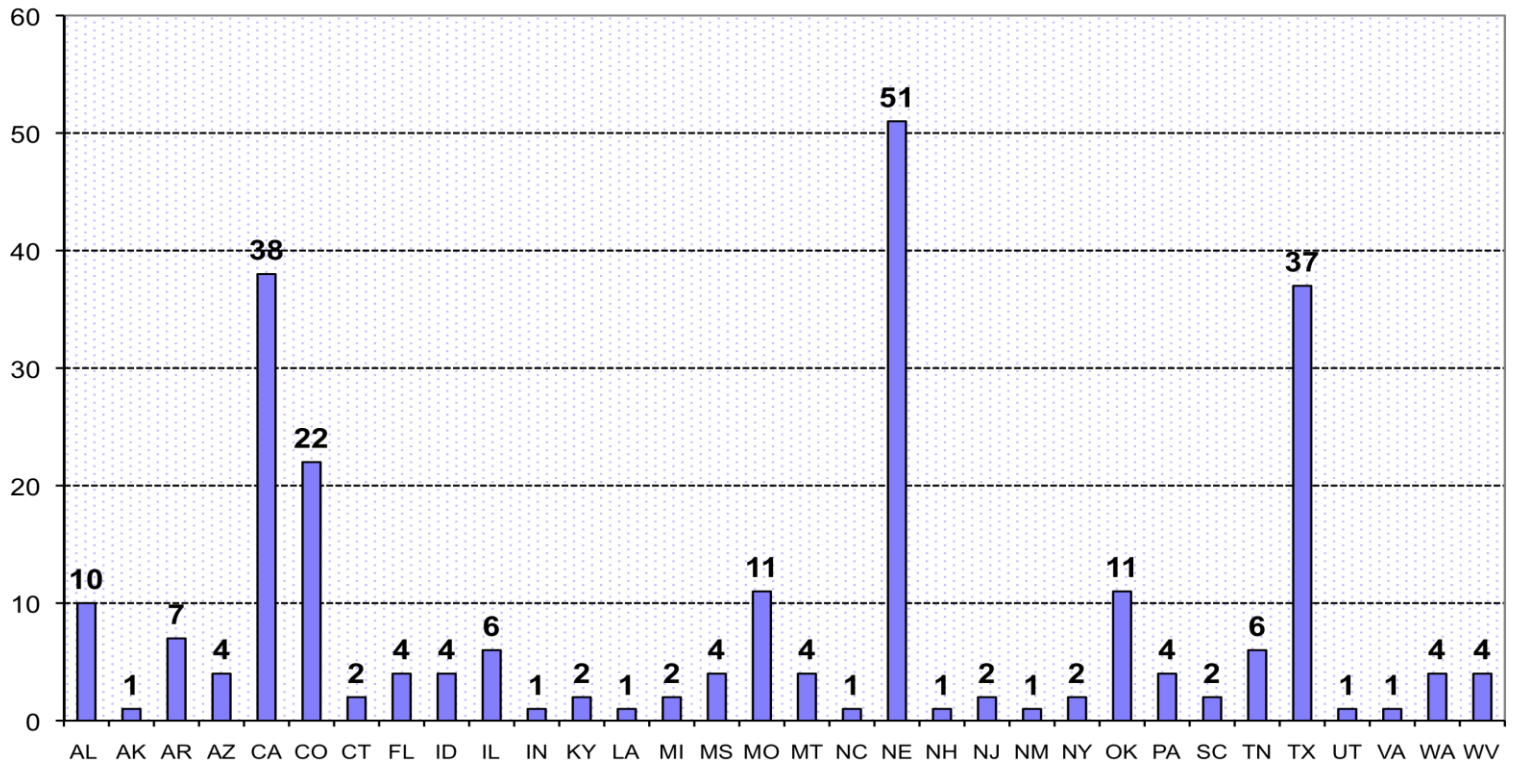
VI. GENERAL ANALYSIS OF CHAPTER 9

CHAPTER 9 FILINGS BY YEAR • 1980-2011
(as of 03/23/2011)



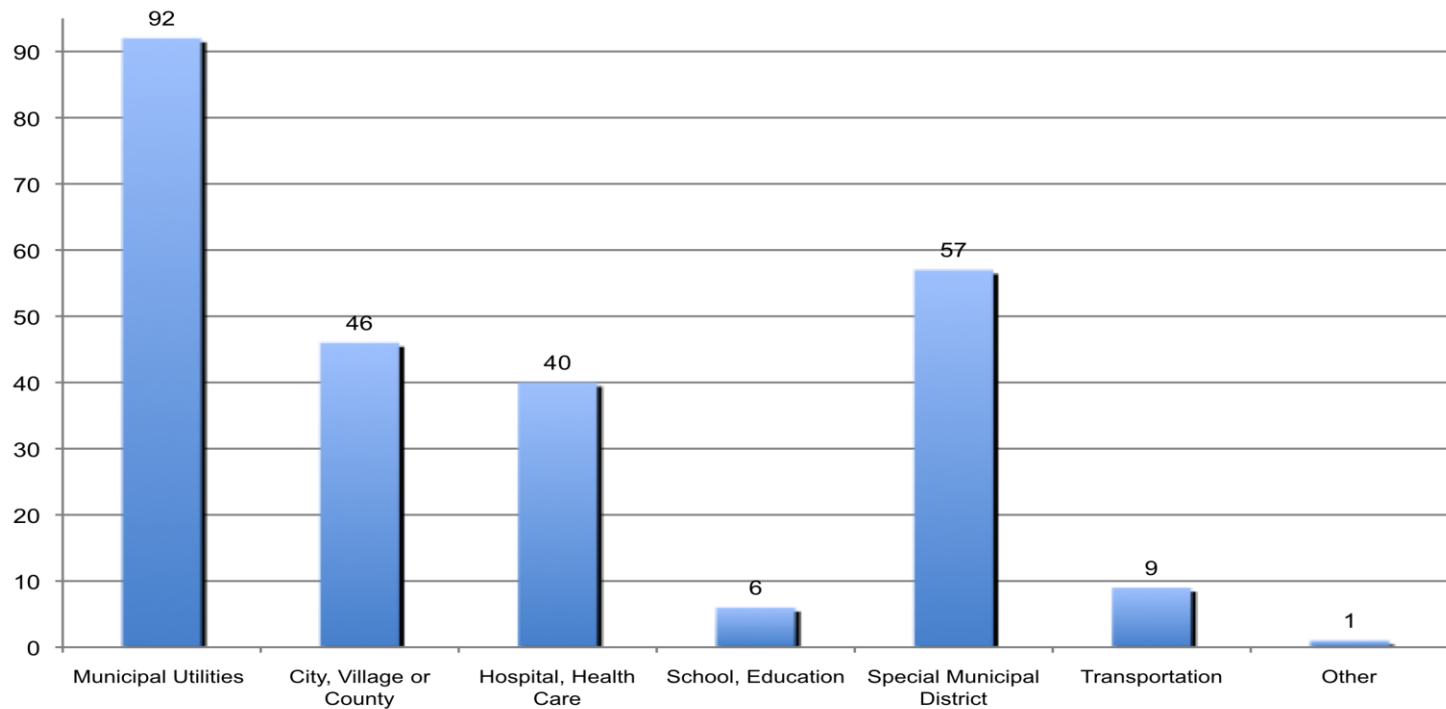
VI. GENERAL ANALYSIS OF CHAPTER 9

CHAPTER 9 FILINGS BY STATE • 1980-2011
(as of 03/23/2011)



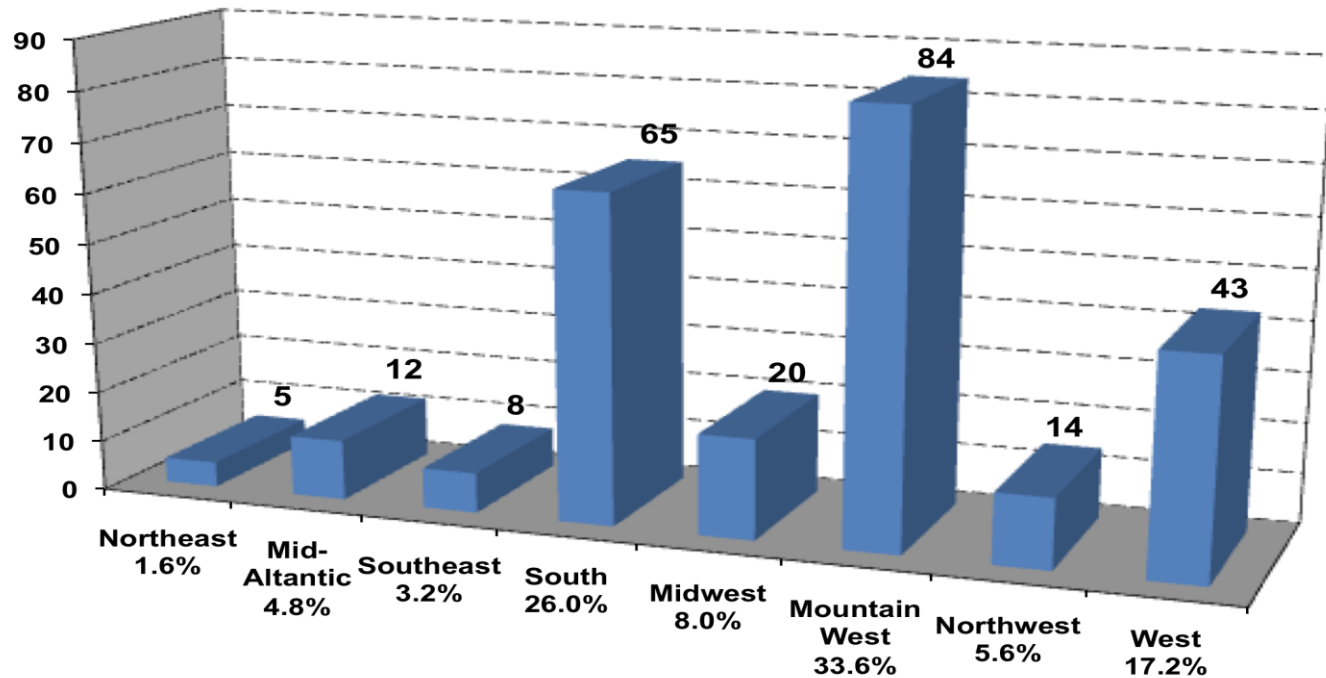
VI. GENERAL ANALYSIS OF CHAPTER 9

CHAPTER 9 FILINGS BY TYPE • 1980-2011
(as of 03/23/2011)



VI. GENERAL ANALYSIS OF CHAPTER 9

CHAPTER 9 FILINGS BY REGION • 1980-2011
(as of 03/23/2011)



VI. GENERAL ANALYSIS OF CHAPTER 9

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

Summary of Chapter 9 Priorities

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

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

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

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

VI. GENERAL ANALYSIS OF CHAPTER 9

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

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

VI. GENERAL ANALYSIS OF CHAPTER 9

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

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

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

VII. THE ROLE OF SPECIAL REVENUES IN CHAPTER 9

- Many municipal bonds are revenue bonds secured by a pledge of revenues derived from the project or a special tax levy
- Section 552 of the Bankruptcy Code generally provides that property acquired post-petition is not subject to a lien resulting from any security interest created prepetition
- Section 928 of the Bankruptcy Code, one of the Municipal Bankruptcy Amendments, renders Section 552(a) inapplicable to revenue bonds secured by “special revenues”
- The security interest in “special revenues” remains valid and enforceable even though such revenues are received after a Chapter 9 filing
- Subsection (b) of Section 928 provides that in the case of project or system financing, the bondholders lien on “special revenues” is subject to necessary operating expenses of the project or system. Thus, these expenses can be put in front of bondholder claims

VIII. RECENT COURT TEST OF SPECIAL REVENUES/STATUTORY LIEN PROTECTIONS

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

VIII. RECENT COURT TEST OF SPECIAL REVENUES/STATUTORY LIEN PROTECTIONS

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

VIII. RECENT COURT TEST OF SPECIAL REVENUES/STATUTORY LIEN PROTECTIONS

- The *Sierra Kings* court has entered an order approving the agreement between the District and the bondholder (1) reaffirming the statutory lien on the *ad valorem* taxes levied or collected for the payment of the bonds and the related funds and accounts, (2) granting a replacement lien on such *ad valorem* taxes and such funds and accounts and (3) recognizing such *ad valorem* taxes as “special revenues” as defined in 11 U.S.C. §902(2)(e) of the Bankruptcy Code
- The Reaffirmation Agreement between the District and the bondholder is incorporated into the court order. This constitutes judicial recognition that bonds, notes and other obligations which have pledged to their payment tax revenues which are “Special Revenues” or are the subject of a “statutory lien” shall be paid on time on their scheduled payment date without any interference from the bankruptcy proceeding. In other words, the automatic stay imposed by the Chapter 9 proceeding and the Plan of Adjustment shall not interfere with the payment of the collected tax revenue or the obligations. This means, as collected, the taxes will be paid on time without interference of the bankruptcy proceeding to satisfy scheduled payments on the bonds when due and nothing in the Chapter 9 proceeding, including the Plan of Adjustment, will interfere with that

IX. HOW IS MUNICIPAL BOND DEBT TREATED IN A CHAPTER 9 PROCEEDING?

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

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

X. OTHER ISSUES IN CHAPTER 9

Labor Issues

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

Non-Bonded Debt or Contracts

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

Priming of Bonded Debt by

- Necessary operating expenses

Priming of Unsecured Debt by

- Administrative claims

Duration of Chapter 9

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

XI. 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

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

- A. A Chapter 9 proceeding deals with municipal debt adjustment and is and should be the absolute last resort for a municipality
 - 1. There have been only approximately 622 Chapter 9 proceedings since 1937 (362 between 1937-1972, 9 between 1973-1979, 251 between 1980-2010)
 - 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

XI. 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
 2. No provision for special standard and hearing before there can be a modification of labor contract. There is no requirement for a determination after hearing that modification or rejection is so necessary to reorganization that without such modification a reorganization would not be possible. In a Chapter 9, a labor contract can be modified or rejected based upon business judgment that, balancing the hardship of rejection or reduction in benefits, is outweighed by likelihood of “liquidation.” For municipality, liquidation is unlikely even though continued municipal operation may be threatened

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

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

XI. 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

XII. 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)

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

Overview of PBGC Claim in Bankruptcy

1. PBGC has two major and somewhat overlapping claims against bankruptcy sponsors of pension plans, namely:
 - “Plan Asset Insufficiency” 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)
 - “Unpaid Funding Contributions” claims which may be a subset of the prior claim
 - In addition, the PBGC sometimes files “premium claims”
 - (PBGC’s premium payment regulation requires payments by plan sponsors for the plan year in which termination of an underfunded plan is initiated and for each year thereafter until the plan is terminated)

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

2. ERISA Lien – Section 4068 of ERISA creates a lien in favor of PBGC upon all property of any employer who does not pay an obligation arising from unfunded benefit liabilities to the PBGC under ERISA Section 4062-64
 - Lien cannot exceed 30% of collective net worth of the employer
 - Tax priority if lien not perfected prior to bankruptcy filing up to 30% of the net worth of Debtor
 - PBGC has asserted that if pension plan is terminated prepetition (and the PBGC's lien is not perfected), PBGC asserts an eighth priority under §507(a)(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

XIII. CONCLUSION

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

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