

# The Future of Public Pensions

## Litigation Surrounding Modification Initiatives

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# The Future of Municipal Pensions

- *Overview of Presentation:*
- Public Pensions: Why Now?
- Constitutional protections for public pensions, and their limits
- Municipal bankruptcy and pension benefits
- What's next? / Lessons learned.

# Retirement Security in America

- One half of Americans do not have employer-sponsored retirement plans;
- • “The average working household has virtually no retirement savings. Among all households the median retirement account balance is \$3,000 for all working-age households and \$12,000 for near-retirement households.”
- • “Two-thirds of working households age 55-64 with at least one earner have retirement savings less than one times their annual income”;
- • Among households with retirement accounts, adequacy of retirement savings varies greatly based on income level, union status, public employee status.

\* “The Retirement Savings Crisis: Is It Worse Than We Think?” Nat’l Institute on Retirement Security, June 2013

# Key Factors in Underfunding:

- Failure to make actuarially-determined annual required contribution;
- Changed actuarial assumptions to reduce required contributions;

## *Top factors associated with underfunding/funding:*

- Budget Choices
  - State Debt to Gross State Product
  - Percentage of employees covered by Social Security Actuarial
  - PUC Funding Method(backloading);
  - Use of 1983 MortalityTable
- Governance
  - Outside investment counsel
  - Practice of making ARC

# Constitutional Protections for Public Pensions

- Nature of the rights of participants
- Modifications/changes to the terms of
- public pensions
- • Current and emerging legal landscape for challenges to these changes

# Nature of the Rights of Participants

- Statutory Pension Rights:
  - Many public pensions are created by statute or ordinance
  - Right to make changes may also be governed by statute or ordinance

# Nature of the Rights of Participants

- Contract
  - Collective Bargaining Agreements –  
May trigger additional protections
- “Contracts Clause” - “No State shall . . . pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts . . .”  
US Constitution (Article I, Section 10)
- • Many States have similar clauses in their State Constitutions

# Nature of the Rights of Participants

- Property
- “Takings Clause” - “private property” shall not “be taken for public use without just compensation.” US Constitution (Fifth Amendment/ Fourteenth Amendment)
- Many States have similar clauses in their State Constitutions

# Nature of the Rights of Participants

- Due Process
- No State shall “deprive any person of life, liberty, or property without due process of law.” US Constitution (Fourteenth Amendment)
- Many States have similar clauses in their State Constitutions

# Modifications to the Terms of Public Pensions

- Contributions – add or increase
- Offer new alternative plans (defined contribution and/or cash balance)
- Early retirement windows
- Modify benefit formula
  - Cost Of Living Adjustments (COLAs)
  - Years considered for average compensation
  - Percentage of compensation

# Current and emerging legal landscape for challenges to these changes

- Two Primary Battles Outside of Bankruptcy:
  - ***When do the benefits or rights vest?***
  - ***If vested, when can they be taken away despite the constitutional protections?***

# When Do These Rights Vest?

- States have four primary approaches: Vesting occurs at first employment
- Vesting occurs as benefits are earned by service
- Vesting occurs at retirement
- Benefits never vest
- • See materials for specific State law on this issue

# Contracts Clause

- Prohibition on Impairment is not Absolute
  - Must balance the clause with the inherent police power of the State

## Three Primary Issues:

1. “Substantial Impairment”?
2. “Legitimate Public Purpose”?
3. “Justified” – i.e., “necessary” and “reasonable”?

*E.g., Home Bldg. & Loan Ass’n v. Blaisdell, 290 U.S. 398, 428 (1934); Energy Reserves Grp., Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411-12 (1983)*

# Takings Clause

- Are these rights “property”?
  - *E.g., Lynch v. United States*, 292 U.S. 571 (1934)

If so, three factors to consider:

- Economic Impact of Claimant
- Interference with Expectations
- Character of the government action

Usually, subsumed by the contract clause .

see *Connolly v. Pension Ben. Guar. Corp.*, 475 U.S. 211, 225 (1986)

# Due Process Clause

- Both “procedural” and “substantive”
- Did the government follow its own
- law/procedure in making the change?
- Is there a legitimate public purpose furthered by a rational means?
- Clearly, this is the easiest of the three to meet

# Municipal Bankruptcy and Pensions

- Why Chapter 9 is Important
- US Constitution prohibits impairment of contracts by states. Many states treat pensions as contracts.
- Contracts can be impaired in bankruptcy, so vested pension rights potentially can be altered.

# Chapter 9 and the 10<sup>th</sup> Amendment

- The Tenth Amendment
- *United States v. Bekins*, 304 U.S. 27 (1938)
- § 903 – Reservation of State power to control municipalities
- § 904 – Limitation on jurisdiction and powers of court

# Chapter 9 Eligibility

- Municipality
  - Authorized by State
- Municipality must be ***specifically authorized***, in its capacity as a municipality or by name, to be a chapter 9 debtor by State law, or by a governmental officer or organization empowered by State law to authorize such bankruptcy filing.

# States that Authorize Municipalities to Use Chapter 9 Bankruptcy:

Specific Authorization	Conditional Authorization	Limited Authorization	Prohibit Filing
Washington; Idaho; Montana; Arizona; Nebraska; Minnesota; Missouri; Arkansas; South Carolina; Alabama; Oklahoma; Texas	Michigan; New York; Pennsylvania; New Jersey; Ohio; Kentucky; North Carolina; Florida; Louisiana; California	Oregon, Colorado; Illinois	Georgia; Iowa (with a limited exception)

# Chapter 9 Eligibility

- **Insolvent**
  - **Desires to effect a plan**
  - **Satisfies at least 1 of 4 additional conditions**
- Majority of creditors by amount in each impaired class have agreed
- Negotiated in good faith and no agreement reached
- Negotiation impracticable
- Municipality reasonable believes that a creditor may attempt to obtain a preference

# Pension and Chapter 9

- What is the nature of the pension right? The answer affects bankruptcy outcome.
- Contract
- Constitutional guarantee
- Statutory

## What type of pension?

- Defined benefit plan
- Defined contribution plan

# Pension and Chapter 9 (Cont.)

- How does the municipality provide the pension?
- Two party agreement: employer-employee (Central Falls)
- Three party agreement: employer-employee-municipal public employee pension system (Detroit)
- Three party agreement: employer-employee-state public employee pension system (Stockton)

# Pension is a Contract

- If a contract, the contract is likely to be executory.
- No explicit definition of “executory contract” in the Bankruptcy Code.
- Generally includes contracts on which performance remains due to some extent on both sides.
- Executory contracts can be rejected, but whether municipality will do so depends on competitive environment and consequences.

# Pension Provisions in State Constitutions and Statutes

- Many state constitutional provisions highlight the contractual nature of municipal pensions. This limits attempts to argue that municipal pensions get special constitutional protection.
- Certain Statutory protections - post-confirmation the municipality must operate in conformity with state law.
- To the extent that state statutes specify municipal pension attributes and the pension is retained in the chapter 9 plan, it may not be possible to modify those attributes.

# What Happens to Pensions in Chapter 9?

- Restructured and reduced (Detroit and Central Falls)
- Left unimpaired (Vallejo, Stockton)
- Rejected and pension rights treated like all other unsecured claims

# What Happens Next?

- After a Chapter 9 plan is drafted and prior to adoption parties retain ability to settle obligations
- Bondholder objections?
- Stakeholder future interactions
- Attempt to hold actuaries accountable for faulty mortality tables?

# Lessons Learned?

- Detroit negotiated settlement that modestly reduced accrued pensions, but requires 6.75% investment return to remain solvent
- Bankruptcy judge in Stockton case approved settlement allowing Stockton to reduce contributions to CalPERs, Franklin Templeton filed appeal with 9<sup>th</sup> Cir. Bankruptcy Court, prolonging the case

# Lessons Learned

- Cities of Vallejo, San Bernadino and Stockton were all hesitant to seek pension reductions and have attempted to “make up” any missed CalPERs contributions
- City of Vallejo now allows limited taxpayer input on certain revenue allocation decisions

Questions?