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## Stockton Bankruptcy Ruling Could Have Big Implications for Public Pensions

In early October, the federal judge in Stockton, CA's bankruptcy case ruled that the city's plan of reorganization could reduce payments to the California Public Employees Retirement System (CalPERS). The ruling does not yet set legal precedent because the judge has not issued a written ruling in the case. However, it is a strong signal that Chapter 9 bankruptcy could offer municipalities a way to reduce unmanageably large pension liabilities that many assumed were protected under state laws.

Stockton filed for Chapter 9 protection in 2012, facing unmanageable budget pressures following the collapse of real estate prices in the city and the subsequent steep drop in property tax revenues. One of the most significant fixed-cost budget items was the city's employee pension benefit obligations, which are administered through CalPERS. Throughout the Stockton bankruptcy, and in similar cases with other California municipalities in financial distress, CalPERS has aggressively fought for full payment of all accrued pension obligations. CalPERS argues that pension obligations are protected under state law and that accrued pension liabilities in the CalPERS system amount to a secured obligation with a lien on any and all assets of the municipality.

CalPERS position in Stockton put it in opposition to the city's other creditors, including Franklin Funds, which holds approximately \$32 million of unsecured city debt in two of its mutual funds. In order to pay CalPERS the full value of its \$1.6 billion claim, Stockton would have to reduce payments to other creditors, including Franklin, to pennies on the dollar. In fact, the city's reorganization plan, which was the subject of the recent court hearing, proposes to pay Franklin one percent of its unsecured claims.

In an oral decision from the bench on October 1st, the bankruptcy judge in the Stockton case stated that federal bankruptcy law overrides state statutes and "the bankruptcy code provides that the [CalPERS] lien can be avoided and be treated as an unsecured claim." The Stockton hearing continues later this month, and the judge may issue a written decision at that point. Only with a written decision does the ruling become legal precedent, and such a ruling would certainly prompt a legal challenge from CalPERS.

The Stockton ruling continues a trend of eroding the protections once afforded to public pension benefits. In many states, legislative changes have reduced benefits, pushed back retirement ages, and even in some cases transformed defined-benefit pension plans into 401k-like defined contribution for new hires going forward. In Detroit's bankruptcy, the negotiated reduction in retiree benefits sent a strong signal that cash-strapped municipalities may not be able to afford to make good on all of the promises made by past leaders. The Stockton ruling appears, at least initially, to support that position.

It is easy to paint Stockton's situation as a "retirees vs. bondholders" fight over city revenues. The reality is not that simple. After initially suggesting that bondholders might only recover 20% of their investments, the current proposed settlement in Detroit envisions bondholders and retirees each receiving approximately 70% of the value of their claims. Going forward, municipalities will likely be challenged to find ways to balance the fixed costs of past and present pension obligations against the need to provide basic levels of public service to their residents while also maintaining the confidence of the capital markets.

We do not expect that the Stockton case will drive a significant uptick in municipal bankruptcies in California, or anywhere else. Bankruptcy is a long, expensive process that truly remains a last resort for municipalities. Rather, Stockton could ultimately provide municipalities with greater leverage to negotiate pension reform without needing to seek Chapter 9 protection. If a definitive ruling in Stockton establishes pension claims in federal bankruptcy as unsecured credits, it could create a strong incentive for public employee pension plans and unions to come to the table earlier to negotiate comprehensive recovery plans that avoid the financial and political pain of a bankruptcy filing.



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