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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re CITY OF STOCKTON, CALIFORNIA., Debtor.	Case No. 2012-32118 D.C. No. OHS-5 Chapter 9 **CALPERS' SUPPLEMENTAL BRIEF IN SUPPORT OF CONFIRMATION OF THE CITY OF STOCKTON'S FIRST AMENDED PLAN OF ADJUSTMENT** Date: October 1, 2014 Time: 10:00 a.m. Place: Robert T. Matsui U.S. Courthouse, 501 I Street, Department C, Fl. 6, Courtroom 35, Sacramento, CA 95814 Judge: Hon. Christopher M. Klein

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The California Public Employees' Retirement System ("CalPERS") files this supplemental brief[1] in support of the First Amended Plan of Adjustment ("Plan") of the City of Stockton (the "City" or "Stockton").[2]

I. PRELIMINARY STATEMENT

At the July 8 hearing (the "Hearing"), this Court directed the parties to provide supplemental briefing regarding an array of tentative interpretations of the California Public Employees' Retirement Law (the "PERL") and the difference the Court perceived between the way the PERL works and the "public rhetoric" (Hr'g Tr. 27:25-28:1, July 8, 2014) involving public employee pensions in California. In this supplemental brief, CalPERS addresses each of the questions raised by the Court and the overarching question of whether CalPERS pension obligations can be adjusted or impaired through a chapter 9 plan of adjustment. For a great number of reasons, the answer to this overarching question is no. Pension benefit obligations of a California municipality cannot be impaired or adjusted by means of a chapter 9 plan of adjustment.

Because the City does not seek to impair its pension obligations in this case, and because there is no evidence before this Court regarding the cost of a viable alternative to CalPERS pensions which could form the basis of a hypothetical alternate plan, there is no justiciable controversy on these issues and the Court does not need to address impairment of the City's pension obligations in order to rule on the confirmation of the City's Plan. To the extent the Court views the consideration of whether pensions can be impaired as necessary to its analysis, it can assume without deciding these matters as is the practice of federal courts. As a practical matter, the hypothetical question of whether CalPERS pensions can be adjusted is of little significance because it is highly unlikely that a chapter

[1] For the convenience of the Court and parties in interest, CalPERS will file a separate pleading that attaches the pertinent parts of exhibits and trial transcripts cited herein. In the case of transcripts, the pleading(s) will attach copies of only the pages cited and surrounding pages for context as necessary. In the case of declarations, the pleading(s) will attach only the declaration itself and those exhibits referred to in the brief, rather than all exhibits to the declaration.

[2] CalPERS is filing, concurrently with this brief, a separate brief (the "Constitutional Brief") addressing why CalPERS pensions cannot be impaired or adjusted in chapter 9 as a matter of constitutional law and why Congress did not intend for the Bankruptcy Code to preempt the PERL.

9 debtor in California will ever wish to travel that path. The California Legislature has authorized only one procedure under which CalPERS member pensions can potentially be reduced—through the drastic measure of plan termination. There is no other mechanism for a participating employer to adjust CalPERS pensions while remaining in the CalPERS system. Stockton, like all of the other prior municipal chapter 9 debtors in California who are CalPERS contracting agencies, has made a sound business decision to maintain its relationship with CalPERS as an important component of Stockton's restructuring plan. The reliable delivery of pension benefits to the City's retirees and employees is an essential aspect of the City's delivery of services for the benefit of its citizens. The preservation of the relationship between the City and CalPERS is also important to the Public Employee's Retirement System (the "System") because Stockton's full participation in the System promotes the stability of the System and the State's objective of fostering interest in public service.

This brief will specifically address the following six questions raised by the Court:

1. Is CalPERS performing a different function when it administers the pensions of state employees than when it administers the pensions of municipal employees? CalPERS is the agency created by the California Legislature to administer the System. Cal. Gov. Code § 20002. The System does not operate differently with respect to the delivery of benefits to its State and municipal employee members and is not akin to a private pension plan in the provision of benefits to any of its members. Rather, benefits are administered from one trust fund under a common body of law. The fact that there are other available options for providing benefits to certain state employees and to municipal employees does not negate the governmental nature of CalPERS, nor alter the fiduciary duties and obligations it owes all of its members and retirees.

2. Can pension benefits administered by CalPERS be reduced? The only situation in which pension benefits may be reduced under the PERL is following the termination of a contracting agency's participation in the System wherein the terminating agency does not pay in full the termination liability.

3. Can the City move to another provider of pension benefits? In the absence of termination, the City could request a transfer to the San Joaquin County Employees' Retirement Association plan (the "County Plan"). However, this would be of no benefit to the City because the costs of participation in the County Plan are likely greater than the costs of participation in CalPERS. In addition, there is no statutory authorization for the transfer of the City's plan assets and liabilities from CalPERS to a new plan established by the City; such a transfer could not occur without authorization from the state legislature. Such a City-established plan would also likely be more costly than the City's current plans with CalPERS. Finally, if the City were to terminate its CalPERS plans, there would be no way for the City to transfer its plans to the County Plan because the PERL provides that only current (non-terminated) CalPERS employers may transfer.

4. Following termination and a reduction in benefits, is CalPERS really the creditor, or is the creditor the members whose benefits were reduced? There is no question that members whose benefits are reduced will suffer the brunt of any benefit reduction. However, termination, followed by a reduction in benefits, has an economic effect on the System as well. When an employer enters the terminated agency pool, actuarial risk transfers from the employer to CalPERS. CalPERS is the party that has the legal duty to collect the termination liability from a terminating employer, and the primary claim of retirees for delivery of benefits is not against their employer but against CalPERS.

5. Following termination, does CalPERS have a lien on the terminated agency's assets for non-payment of the termination liability? CalPERS' lien on the assets of a terminated agency under California Government Code section 20574 is not avoidable under section 545 of the Bankruptcy Code. While municipal debtors have the ability to avoid certain statutory liens under section 545, the lien granted to CalPERS is not the kind of lien that can be avoided.

6. Can the relationship with CalPERS be rejected as an executory contract? The relationship between CalPERS and a participating employer with respect to contribution obligations is not based on an executory contract that can be rejected under section 365 of the Bankruptcy Code. California Government Code section 20487 states this directly. If an employer were to attempt to reject its contract with CalPERS, the employer would no longer be eligible to be a debtor under chapter 9.

CalPERS is proud of its decades long tradition of protecting the integrity of the System and its consistent delivery of promised benefits to CalPERS retirees. CalPERS values its relationship with the City and earnestly hopes for a promising future for the City once it has reorganized and is financially stable after its emergence from chapter 9. The City's objectives and those of the State of California are best served by confirmation of Stockton's Plan without comment on issues that could have damaging effects of unknown proportion on the public employment retirement systems of the State of California. CalPERS remains hopeful that the Court will reach a decision to accomplish these important objectives.

II. ARGUMENT

A. CalPERS' Comments Regarding the Court's Tentative Interpretation of the PERL.

1. CalPERS is an Arm of the State Exercising a Governmental Function in Administering the Public Employees' Retirement Fund.

The Court has suggested that CalPERS is two different things, depending on whether it is administering the pension benefits of State employees or municipal employees. Hr'g Tr. 28:10-29:20,

July 8, 2014. The Court also appears to question whether CalPERS exercises a governmental function when it administers pension benefits to municipal employees. Hr'g Tr. 29:14-20, July 8, 2014. In fact, the System does not operate differently with respect to the delivery of benefits to its State and municipal employee members. Benefits are administered from one trust fund under a common body of law, and CalPERS is an arm of the State of California exercising a core governmental function in the administration of a statewide public retirement system.

i. CalPERS Is a Single Agency Administering One Fund and Managing Benefits in the Same Manner for Both State and Municipal Employees.

As explained in the testimony of CalPERS Deputy Chief Actuary Mr. David Lamoureux, CalPERS does not segregate funds received from the State as employer from those received from municipal employers. Hr'g Tr.167:6-9, May 14, 2014. All funds, whether received from the State, a municipality, or members, are deposited in the Public Employees Retirement Fund ("PERF"), which is maintained in the State Treasury. The PERF "is a trust fund created, and administered in accordance with [the PERL], solely for the benefit of the members and retired members of this system and their survivors and beneficiaries." Cal. Gov. Code § 20170; *see also* Cal. Const., art. XVI, § 17(a) ("The assets of a public pension or retirement system are trust funds and ***shall be held for the exclusive purpose*** of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.") (emphasis added). Again, nothing in the PERL differentiates between the funds received from the State and the funds received from municipalities, and the California Legislature recognized that all such monies are part of the same State fund—the PERF.

The Court has suggested that CalPERS' relationship with municipal employers participating in the System is fundamentally different from its relationship with the State. Hr'g Tr. 28:10-29:20, July 8, 2014. This is incorrect. CalPERS' relationship with State members and municipal employer members is materially identical. The Court correctly noted that, under the PERL, the *means* by which municipal employers enter the System differs from the way State employees become covered. Generally, State employees become members in CalPERS merely by virtue of being employed by the

State.[3] Hr'g Tr. 165:19-24, May 14, 2014. In contrast, public employees that are not employed by the State generally may participate in CalPERS only if the local government or public agency that employs them elects to provide pension benefits through the System. Cal. Gov. Code § 20460. In addition, benefit formulas are established differently in that State members' benefit rates are largely established by legislation whereas municipal employer members' benefit formulas are established by the municipal employer's selection of formulas from statutorily prescribed options. However, once a municipal employer elects to participate in CalPERS, the relationship between it and CalPERS is identical to that between CalPERS and the State with respect to the administration and delivery of pension benefits.

For all members and retirees in the System, whether State or municipal, CalPERS must ensure those individuals' rights to their full earned benefits. *City of Oakland v. Pub. Employees' Ret. Sys.*, 95 Cal. App. 4th 29, 39-40 (2002). Once a municipal employer has elected to join CalPERS, the municipal employer is bound by the statutory provisions governing the System and the decisions of the CalPERS Board of Administration (the "CalPERS Board"). Cal. Gov. Code § 20506; *City of Oakland*, 95 Cal. App. 4th at 55. For this reason, the City's obligations to CalPERS are not defined by the language of the City's agreements with CalPERS; rather, they are defined by the same statutory provisions that govern the State's obligations to CalPERS. Once a city elects to participate in CalPERS, its employees' rights to pension benefits under the System become indistinguishable from the rights of State employees. Thus, no principled distinction exists between the relationships of CalPERS with the State and a municipality with respect to the administration of pension benefits. CalPERS is a single agency, administering a single fund under consistent and materially identical rules for both State members and retirees and municipal employer members and retirees.[4]

[3]Not all State employees participate in CalPERS. There are classifications of state employees that may choose whether to participate in CalPERS. Cal. Gov. Code §§ 20320-20327. Some employees may be excluded from membership. Cal. Gov. Code §§ 20300-20309.5.

[4]The only significant difference is that a municipal employer's participation in the System can be terminated, whereas a State employer's cannot.

ii. CalPERS Is an Agency of the State of California Exercising a Core Governmental Function.

The California Legislature has declared that the purpose of the System "is to effect economy and efficiency in ***the public service*** by providing . . . a retirement system consisting of retirement compensation and death benefits." Cal. Gov. Code § 20001 (emphasis added); *see also* Cal. Gov. Code § 20058 (defining "Retirement system" and "the System" without making a distinction between State members and municipal members); Cal. Gov. Code § 20069 (defining "State service" and expressly including in that definition "service rendered as an employee or officer . . . [of] a contracting agency[.]").[5] The PERL is concerned with "public service" as a whole. PERL section 20370 defines "member" to include both state and participating municipal employees and CalPERS obligations run equally to all members. Cal. Gov. Code §§ 20151(a)(1) & 20164. The California Supreme Court agrees, noting that the System serves two primary objectives: "to induce persons to enter and continue in public service, and to provide subsistence for disabled or retired employees and their dependents." *Wheeler v. Bd. of Admin.*, 25 Cal. 3d 600, 605 (1979).

CalPERS "is a unit of the Government Operations Agency." Cal. Gov. Code § 20002; *accord Westly v. California Pub. Employees' Ret. Sys. Bd. of Admin.*, 105 Cal. App. 4th 1095, 1116 (2003) (affirming trial court finding that "CalPERS is a part of the state"); *see also City of Anaheim v. State of California*, 189 Cal. App. 3d 1478, 1482 (1987) (referring to CalPERS as "a state agency."). According to its website, the Government Operations Agency "is responsible for administering ***state operations*** including procurement, information technology, and human resources." http://www.govops.ca.gov (last visited August 10, 2014) (emphasis added). It also comprises the following governmental units, in addition to CalPERS: the Office of Administrative Law, Franchise Tax Board, Department of General Services, Department of Human Resources, State Personnel Board, State Teachers' Retirement System, Department of Technology, and the California Victim

[5]The term "Contracting agency" is defined as "any public agency that has elected to have all or any part of its employees become members of this system and that has contracted with the board for that purpose." Cal. Gov. Code § 20022. The term "Public Agency" is defined as "any city, county, district, other local authority or public body" within California. Cal. Gov. Code §20056. Section 20057 also includes a number of agencies specifically identified as public agencies for purposes of the PERL.

Compensation and Government Claims Board. *See id.* Thus, as a matter of California law, CalPERS is, as the *Westly* court put it, "part of the state" of California.

CalPERS' status as an arm of the State performing a governmental function is further evidenced by the fact that CalPERS pension plans are governmental plans not governed by Title I and Title IV of the Employee Retirement Income Security Act of 1974 ("ERISA"), nor are any of the CalPERS plans protected by the Pension Benefit Guaranty Corporation ("PBGC"). 29 U.S.C. § 1003(b)(1); Hr'g Tr. 162:23-25, May 14, 2014. State-run pension plans like CalPERS are expressly exempt from regulation under Titles I and IV of ERISA because such plans are a traditional sovereign function in which "the Federal Government should not interfere." *Feinstein v. Lewis*, 477 F. Supp. 1256, 1261 (S.D.N.Y. 1979) (quoting ERISA's legislative history), *aff'd* 622 F.2d 573 (2d Cir. 1980). *See also Hightower v. Tex. Hosp. Ass'n*, 65 F.3d 443, 448 (5th Cir. 1995) (per curiam) ("Although applying ERISA to public pension plans was considered, Congress was reluctant to interfere with the administration of public pension plans due to the resulting federalism implications."); *Alley v. Resolution Trust Corp.*, 984 F.2d 1201, 1206 (D.C. Cir. 1993) (R.B. Ginsburg); *Roy v. Teachers Ins. & Annuity Ass'n*, 878 F.2d 47, 49 (2d Cir. 1989); *Rose v. Long Island R.R. Pension Plan*, 828 F.2d 910, 914 (2d Cir. 1987). Thus, by purposefully excluding governmental pension plans like CalPERS from Title I and Title IV of ERISA, Congress expressly recognized that the administration of such pension plans constituted a traditional governmental function of the State.

CalPERS' authority and basis for administration of public pensions is governed by State statute. In addition, the composition of the CalPERS Board and the terms of its members are also set by statute. *See* Cal. Gov. Code §§ 20090 & 20095.[6] Most importantly, the State constitution and State

[6]The CalPERS Board consists of 13 members who are elected, appointed, or hold office *ex officio*. Its composition is mandated by law and cannot be changed unless approved by a majority of the registered voters in the State. The three appointed members are: (a) Two appointed by the Governor—an elected official of a local government and an official of a life insurer; and, (b) One public representative appointed jointly by the Speaker of the Assembly and the Senate Rules Committee. The four *ex-officio* members are: (a) The State Treasurer; (b) The State Controller; (c) The Director of the California Department of Human Resources; and, (d) A designee of the State Personnel Board. The six elected members are: (a) Two elected by and from all CalPERS members; (b) One elected by and from all active State members; (c) One elected by and from all active CalPERS school members; (d) One elected by and from all active CalPERS public agency members

statute designate CalPERS as the fiduciary responsible for the provision of pension benefits. Cal. Const., art. XVI, § 17(a), Cal. Gov. Code § 20151.

Courts have also found that CalPERS does not serve a proprietary function but rather serves a governmental function. In the context of determining whether CalPERS was a "citizen" of California for purposes of diversity jurisdiction,[7] after noting CalPERS' statutory purpose, statutory organization and the California Supreme Court's interpretation of the PERL, one federal district court, rejected the notion that "CalPERS merely serves a proprietary function in light of these broader objectives." *Id*. at *4. In concluding that CalPERS serves a central governmental function, the *Moody's* court rejected the very same concern raised by this Court :

> Defendants also argue that the fact that CalPERS serves non-state employees of local districts and other public agencies indicates that it does not perform an inherently central government function. The Second Circuit rejected this argument in holding that the retirement system at issue in that case was an arm of the state. *McGinty v. New York*, 252 F.3d 84, 98 (2d Cir. 2001). The court found that 'although the Retirement system does not service state employees exclusively, it assists *in the business of the state* by enabling the state to meet its pension and benefits obligations.' *Id.* The Court is persuaded by this reasoning. The fact that CalPERS serves other agencies does not render it an entity separate from the state. In fact, as plaintiffs point out, the broad coverage provided by CalPERS tends to show that ***it performs a central governmental service*** because it addresses 'matters of statewide rather than local or municipal concern.' *Beentjes v. Placer County Air Pollution Control Dist.*, 397 F.3d 775, 782 (9th Cir. 2005).

Moody's at * 5 (alterations omitted) (emphasis added). Two courts in this District have reached similar conclusions regarding the role that the System plays in California. *See, e.g., Arya v. CalPERS*, 943 F. Supp. 2d 1062, 1072 (E.D. Cal. 2013) (adopting reasoning in *Moody's*, and in particular

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(employed by contracting public agencies); and (e) One elected by and from the retired members of CalPERS. *See* Cal. Gov't Code § 20090. Thus, the PERL creates only one Board to manage and the run the System. The various terms for the various Board members are fixed by statute. *See* Cal. Gov't Code § 20095.

[7]The standards courts consider to determine whether a State agency is a "citizen" for purposes of 28 U.S.C. § 1332 (the diversity statute) or an "arm of the State" for purposes of determining sovereign immunity are functionally the same. *CalPERS v. Moody's Corp.*, Nos. C 09–03628 SI, C 09–03629 JCS, 2009 WL 3809816, at *2-3 (N.D. Cal. Nov. 10, 2009) (hereinafter *Moody's*). Both require a court to determine, *inter alia*, whether the entity in question is performing a central or traditional governmental function. *Id.* at *3 (citing *Mitchell v. Los Angeles Cmty. Coll. Dist.*, 861 F.2d 198, 201 (9th Cir. 1988). As such, cases concluding that CalPERS, or other similarly situated pension systems, are not "citizens" for purpose of diversity jurisdiction or are "arms of the State" for sovereign immunity purposes are dispositive on the question of whether CalPERS performs a traditional governmental function.

recognizing that CalPERS performs "central governmental functions."); *see also Barroga v. Bd. of Admin. CalPERS*, No. 2:12-cv-01179, 2012 WL 5337326 at *5 (E.D. Cal. Oct. 26, 2012) (concluding CalPERS is a "state agency" entitled to sovereign immunity), *aff'd on other non-constitutional grounds*, 2014 WL 2750280 (9th Cir. June 18, 2014); *See also Kaplan v. CalPERS*, No. 99-15295, 2000 WL 540932, at *1 (9th Cir. May 3, 2000) (determining CalPERS is entitled to sovereign immunity). California courts have come to a similar conclusion. *See, e.g.*, *Westly*, 105 Cal. App. 4th at 1118 (noting PERL is "intended to protect the public fisc, thereby protecting the interests of the state's taxpaying citizens.").

Federal courts have also come to a similar conclusion with respect to other state pension systems. As noted above, the Second Circuit held that simply because New York State's retirement system "also facilitates pension benefits for municipal employees does not mean it is not serving state employees, since it was originally created as a plan for state employees." *McGinty*, 251 F.3d at 98 (2d Cir. 2001). Thus, the court had no trouble concluding that the New York system performed a traditional state function. *Id*. Similarly, a federal district court in Virginia determined that the Virginia Retirement System was not a "person" for purposes of 42 U.S.C. § 1983 and was entitled to sovereign immunity, even though it administered pension benefits for "teachers, state employees, and employees of participating political subdivisions." *Sculthorpe v. Virginia Retirement Sys.*, 952 F. Supp. 307, 309-10 (E.D. Va. 1997); *see also Public Employees Retirement Assoc. of New Mexico v. Clearland Securities*, No. Civ 11-0931 JB/WDS, 2012 WL 2574819 at **26-34 (D.N.M. June 29, 2012) (determining that New Mexico's retirement system, which included municipal employees, "operates a state-wide retirement system" and was therefore entitled to sovereign immunity as an "arm of the state."); *Ernst v. Rising*, 427 F.3d 351, 361 (6th Cir. 2005) (en banc) (holding that Michigan's judge's retirement system was an "arm of the state" and collecting cases holding the same).

As the Sixth Circuit held:

> Plaintiffs contend that the retirement system is more proprietary than governmental because it operates for the benefit of its members only and not for the entire State. But the system still serves a statewide purpose—providing retirement benefits for the

> judicial officers of the third branch of state government as well as other prominent statewide officials, all of whom indisputably serve the state.

Ernst, 427 F.3d at 366.

By promoting public service and providing pension security to state and municipal employees alike, CalPERS is serving the State because the State, as a whole, benefits from being able to recruit quality public servants and from the increased economic security for *all* of its public servants, not just those who work directly for the State. Providing for public service is a quintessential governmental role. It would be an odd rule of decision to conclude that a system based on the promotion of public service and long-term financial security for all public employees did not constitute a traditional governmental function simply because it offered those benefits to *too many* public employees.

All of this demonstrates that CalPERS, as the administrator of the statewide pension system for the State of California, performs a traditional governmental state function by (1) promoting public service of all kinds and (2) by providing financial security to public servants who are vital and necessary to the administration of the State.

iii. Section 903 Makes No Distinction Between Governmental and Proprietary Functions.

There is no purpose served by drawing a distinction between governmental and proprietary functions in chapter 9 because section 903 of the Bankruptcy Code makes no such distinction in its protection of a State's power to control its municipalities. A distinction between governmental and proprietary functions *can* be found in section 362(b)(4) of the Bankruptcy Code, which excepts from the automatic stay a government's exercise of its "police and regulatory power." 11 U.S.C. § 362(b)(4). Section 903's mention of State power, however, places no qualification on the power exercised by a State that is protected from interference by bankruptcy courts; section 903 broadly protects "the power of a State to control" its municipality. Based on the difference in the use of the term "power" between sections 903 and 362(b)(4), the Court must draw the conclusion there is no qualification on the type of power—whether it is a traditional or proprietary government function. While the historical precursors to section 903 may have been based on this distinction, at the time Congress enacted currently applicable chapter 9 in the 1970s, the Supreme Court had long since discarded the governmental/proprietary distinction that had vexed courts for years. *See, e.g., New*

York v. United States, 326 U.S. 572 (1946); *In re City of Stockton*, 478 B.R. 8, 19 & n.4 (Bankr. E.D. Cal. 2012); *See also* M. McConnell & R. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. Chi. L. Rev. 425, 462-63 (1993) (noting "collapse" of the "governmental/proprietary distinction"). Therefore, even if CalPERS were performing a "proprietary" role, section 903 would still apply and would prevent any attempt to interfere with its State-mandated role in controlling the City's participation in the System.

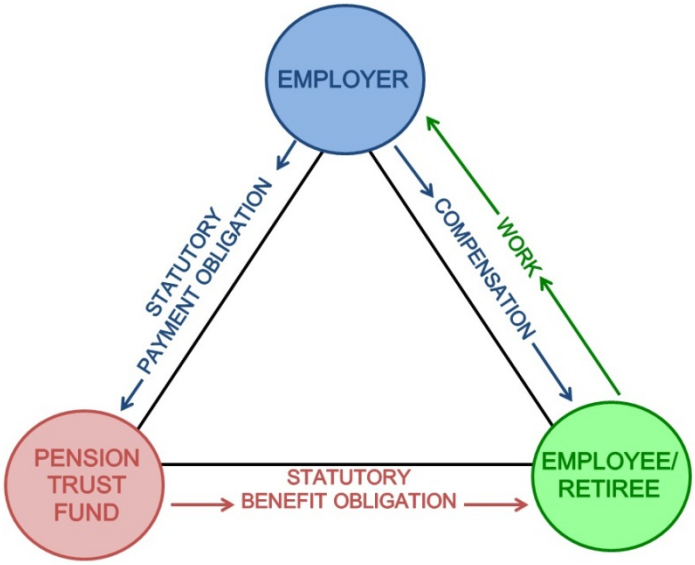
Even if the distinction between governmental and proprietary roles is relevant, in enforcing the PERL, CalPERS is exercising police and regulatory (*i.e.*, governmental) powers. Any act to enforce the PERL would be in furtherance of compliance with State laws including State labor laws, including Cal. Lab. Code § 227.[8] Failure to comply with section 227 is unlawful under California law. Seeking compliance with state labor laws has been held to be an exercise of a government's police and regulatory powers. As stated by one court, "[l]itigation by governmental units to enforce federal and state labor laws uniformly has been excepted from the stay under § 362(b)(4)." *In re Ngan Gung Rest., Inc.*, 183 B.R. 689, 691 (S.D.N.Y. 1995) (citing cases). Similarly, the Ninth Circuit has previously held that an action by the National Labor Review Board to assess back pay against a debtor was an exercise of a government's police and regulatory powers. *NLRB v. Continental Hagen Corp.*, 932 F.2d 828, 834-35 (9th Cir.1991).

[8] California Labor Code §227 provides: If an employer has made withholdings from an employee's wages pursuant to state, local, or federal law, or has agreed with any employee to make payments to a health or welfare fund, pension fund, or vacation plan, or other similar plan for the benefit of the employees, or a negotiated industrial promotion fund, or has entered into a collective bargaining agreement providing for these payments, it shall be unlawful for that employer willfully or with intent to defraud to fail to remit the withholdings to the proper agency or to fail to make the payments required by the terms of that agreement. A violation of any provision of this section when the amount the employer failed to pay into the fund or funds exceeds five hundred dollars ($500) shall be punishable by imprisonment pursuant to subdivision (h) of Section 1170 of the Penal Code, or in a county jail for a period of not more than one year, by a fine of not more than one thousand dollars ($1,000), or by both that imprisonment and fine. All other violations shall be punishable as a misdemeanor. In a criminal proceeding under this section, any withholdings that are recovered from an employer shall be forwarded to the appropriate fund or plan and, if restitution is imposed, the court shall direct to which agency, entity, or person it shall be paid.

2. With Respect to Municipal Employers, the System Is Based on a Triangular Statutory Structure Governing the Relationship Among CalPERS, Municipal Employers, and Retirees.

CalPERS provides retirement benefits to retired employees of participating municipal employers through a tripartite relationship: (1) the municipality elects to participate in the System, triggering the application of laws and regulations governing the provision of pension benefits to the municipality's employees through CalPERS; (2) the public servant has an employment contract with the municipality that requires pension benefits to be provided through CalPERS; and (3) CalPERS has a fiduciary responsibility to provide and protect the pension benefits of those employees, now CalPERS members.

The following diagram may be useful to understanding the relationship among CalPERS, its members, retirees, and participating employers:



Under this triangular relationship, CalPERS' obligations to its members and retirees are distinct and separate from the participating employer's obligations to its employees. The participating employer promises the pension benefit to its employees, and obligates itself to participate in CalPERS and to make the required contributions to CalPERS as determined by CalPERS to fund the promised benefits. Once the employee retires, the obligation to pay pension benefits to retirees and their beneficiaries is primarily owed by CalPERS, (Cal. Gov. Code § 20151(a)(1)) and if the

employer fails to perform its obligations to pay CalPERS, CalPERS remains obligated under statute to pay the benefits promised by the employer. However, CalPERS may enforce the employer's payment obligations to CalPERS, may terminate the relationship if the employer fails to make its required contributions, and may reduce benefits as necessary if the employer fails to pay in full its termination liability.

Similarly, an employer's obligation to CalPERS is distinct from the employer's obligations to its employees. The relationship between CalPERS and a participating employer as it relates to contributions and other employer obligations is statutory, not contractual. As the California Court of Appeals held long ago in explaining the CalPERS "contract" that exists with cities like Stockton:

> The statutory 'contract' here involved possesses few of the essentials of a commercial contract. The system is one whereby contributions by the employees and by the state (or, as here, by the participating agency) purchase certain benefits determined, and periodically redetermined as to cost, by actuarial computations. [. . .] When a public agency blankets its employees into the system, the so-called 'contract' which it executes is nothing more than an undertaking to collect required contributions from its employees and, adding therefor the requisite amount of its own funds, pay the money to the board.

Jasper v. Davis, 164 Cal. App. 2d 671, 675 (1958). The payment obligation owed by the employer to CalPERS is not one of contract, but of statute. Cal. Gov. Code § 20506; *see also City of Oakland*, 95 Cal. App. 4th at 55 ("[B]y entering into a contract with the PERS system, and extending that contract to include safety members, the City bound itself to follow the applicable statutory definitions governing firefighters . . . .").[9] Whether or not the employer honors its obligations to its employees, it retains a statutory duty to pay CalPERS the contributions required to fund the promised benefits. Cal. Gov. Code § 28031. Rejection or breach of its contracts with employees does not affect an employer's duty to contribute to CalPERS. This duty is statutorily imposed by the PERL and is unaffected by any contracts between the employer and its employees. It was the exercise by the State of California of its governmental powers that created these statutory obligations, independent of any

[9] *See also City of Los Altos v. Bd. of Admin., PERS*, 80 Cal. App. 3d 1049, 1052 (1978) ("The state statute dealing with PERS and the board of administration's interpretation and enforcement of those statutes preempt any municipal provisions."); *Marsille v. City of Santa Ana*, 64 Cal. App. 3d 764, 771 (1976) ("The Legislature has enacted statutes dealing with retirement of public employees. State statutes dealing with PERS matters preempt municipal provisions . . . .") (citation omitted) (citing former version of § 20506).

contractual rights and obligations between the employer and employee while in the employment relationship.

3. CalPERS Has an Independent Role as the Trustee and State Authorized Administrator of the Pension System.

The Court has suggested that a city's *retirees*, and not CalPERS, would be creditors of a city in the event that a city's pension obligations were impaired. Hr'g Tr. 39:21-40:2, July 8, 2014. The Court also appears to tentatively characterize CalPERS as a mere pass-through entity. Both tentative conclusions are incorrect. CalPERS, as trustee of a participating employer's pension plan and of the System, has creditor standing and the right to enforce a participating employer's obligations under the PERL.[10] In fact, CalPERS can bring a state-court collection action against a contracting agency that defaults on its pension contribution obligations. Cal. Gov. Code §§ 20572(b), 20831, 20537 and 2 Cal. Code of Reg. §§ 565, 565.2.[11]

Additionally, the fact that money paid by a city to CalPERS is held in trust for members does not make CalPERS a mere "pass through" because CalPERS is the party with the right to enforce a city's obligations under the PERL. This conclusion is supported by the Supreme Court's decision in *Nathanson v. NLRB*, 344 U.S. 25 (1952). In *Nathanson*, the court held that the National Labor Relations Board (the "NLRB") was entitled to file a proof of claim for back pay in an employer's bankruptcy even though such monies were ultimately paid to the employees. *Id*. at 27. The court reasoned that Congress designated the NLRB as its agent and the only party with the ability to enforce the National Labor Relations Act, 29 U.S.C. § 151 *et. seq*. *Id*. Since *Nathanson*, courts have extended the Supreme Court's holding to conclude that "any time a governmental entity has a right of action against a debtor, the governmental entity is a creditor as defined under the Bankruptcy Code." *In re First Alliance Mortgage Co*., 269 B.R. 428, 435 (C.D. Cal. 2001). Thus, the Third Circuit held that a labor union was entitled to creditor status under the Bankruptcy Code despite the fact that the

[10]The City in this case remains current on its obligations to CalPERS. CalPERS would be a creditor of a City in the event of default by a City on its contribution obligations.

[11] For example, CalPERS recently filed such a collection action against the City of Compton. CalPERS v. City of Compton, Case No._34-2012-00132360, Superior Court for the State of California, County of Sacramento, September 21, 2012.

wages under the collective bargaining agreement sought to be enforced were ultimately payable to the employees. *In re Altair Airlines*, 727 F.2d 88, 90 (3d Cir. 1984). In so holding, the court said: "The debtor urges that while federal common law permits a union to sue to enforce a collective bargaining agreement, that law does not authorize the union to 'collect' the wages, but only to cause them to be passed through to its members. That distinction is entirely too metaphysical to serve as a guide for construction of the Bankruptcy Code." *Id*. at 90.

Even if individual employees and retirees have standing to bring suit on their own behalf to enforce a city's promise to provide pension benefits and to meet its contribution obligations to CalPERS under the PERL, CalPERS is still independently authorized and responsible for the enforcement of a city's statutory contribution obligations, including payment of any termination liability. *See e.g., In re Egea*, 236 B.R. 734, 742 (Bankr. D. Kansas 1999) ("The designation of four classes of plaintiffs—the Secretary, plan participants, beneficiaries, fiduciaries—in 29 U.S.C. § 1132(a)(2) does not disqualify the Secretary from instituting civil enforcement proceedings."); *SEC v. Bilzerian (In re Bilzerian)*, 1995 WL 934184 at *2 (M.D. Fla. May 15, 1993) (stating that *Nathanson* "recognized a government agency's ability to enforce a debt as a creditor in a bankruptcy case even though the agency will not be the ultimate recipient of the money.").

For the above reasons, in the event of nonpayment by a hypothetical city, CalPERS is a creditor with the right to enforce the city's statutory pension obligations.

4. <u>The Sources of Funding to Support Pension Obligations Administered by CalPERS.</u>

This Court has stated that the funds held by CalPERS for the benefit of the City's employees come from three different funding sources: employer and member contributions, investment earnings, and underfunding. Hr'g Tr. 32:13-18, 33:5-8, July 8, 2014 While there are three sources of funding for the City's accounts, underfunding is not a separate source. Instead, employer and member contributions constitute two sources, and investment returns on the fund assets constitute the third source of funding.

The first and second sources of funding supporting benefits obligations are member and employer contributions. Though the amounts of these contributions are interrelated, they constitute

two distinct funding sources and reside in two separate accounts in the member's trust fund. Hr'g Tr. 201:10-22, May 14, 2014. As a contracting agency, the City has selected benefit formulas dictating how much money members receive upon retirement. *Id.* at 201. Under the City's current contract with CalPERS, for employees hired on or before December 28, 2012, the City elected the "3 percent at 50" formula for the safety members and the "2 percent at 55" formula for the miscellaneous members. Cal. Gov. Code §§ 21354 & 21362.2. In addition, members first hired in miscellaneous or fire classifications after December 28, 2012, are eligible for a "2 percent at 60" formula if a miscellaneous member and a "3 percent at 55" formula if a fire member. Cal. Gov. Code §§ 21353 & 21363.1. Further, under the California Public Employees' Pension Reform Act of 2013 ("PEPRA"), employees hired on and after January 1, 2013 who are also new members (as that term is defined under PEPRA) are only eligible for the "2 percent at 62" formula for miscellaneous members and "2.7 percent at 57" formula for safety members. Cal. Gov. Code §§ 7522.20 & 7522.25.

CalPERS must set the funding requirement to service the benefit obligations promised by the City by determining how much money must be contributed to the plan to fund the benefits under the selected benefit formula. *See* Hr'g Tr. 201:10-14, May 14, 2014. The total contribution includes (1) the "Normal Cost," which is the amount needed to fund benefits earned over the course of the upcoming year (Hr'g Tr. 168:15-17, May 14, 2014); and (2) a contribution related to any unfunded liabilities. *Direct Testimony Declaration Of David Lamoureux In Support Of CalPERS' Response To Franklin's Objection To Confirmation Of The City Of Stockton's First Amended Plan Of Adjustment* (the "Lamoureux Decl.") [Dkt. Nos. 1439-1444], Ex. 6 at 52; Ex. 7 at 139. For the 2014-15 fiscal year, the total contribution rate is expected to be 41.385 percent and 20.090 percent of payroll for safety and local employees, respectively. Lamoureux Decl., Ex. 6 at 52; Ex. 7 at 139.

The member contribution is set by statute and based on the benefit formula selected by the agency. *Id.* Under the chosen benefit formulae, miscellaneous members must contribute seven percent (except for new members under PEPRA formula who contribute 6.25%) and safety members must contribute nine percent (except for new members under PEPRA formula who contribute 11.25%) of payroll to support future benefit payments. Cal. Gov. Code § 20677(a)(2) & 20678(a).

Member contributions are set against the Normal Cost component of the total annual contribution. *See* Hr'g Tr. 168:20-25, May 14, 2014; Lamoureux Decl., Ex. 6 at 52; Ex. 7 at 139. Thus, member contributions pay a portion of the Normal Cost and the employer pays the remainder.

Employer contributions are equal to the Normal Cost not covered by the member contributions plus an amount related to any unfunded liabilities of a plan. Lamoureux Decl., Ex. 6 at 52; Ex. 7 at 139. Both the Normal Cost and unfunded liabilities fluctuate from year to year, so the employer contribution likewise fluctuates. Because the employer contribution includes a cost related to unfunded liabilities, underfunding cannot be described as a distinct "source" of funds for a plan. Rather, unfunded liability is merely a component of the calculation of the employer's future contribution obligations in connection with the annual valuation and contribution rate determination by CalPERS. *See* Hr'g Tr. 170:10-22, May 14, 2014.

The member and employer contributions are also paid into separate accounts at distinct times. The City's pension plans have separate member and employer accounts, into which the respective contributions are paid. Hr'g Tr. 202:16-18. Moreover, the City makes its contributions at a different time from the members. While member contributions are made at the time of payroll, employer contributions must be paid by the 15th day following the last day in the pay period to which they relate. Lamoureux Decl., ¶ 20. For all of these reasons, member and employer contributions constitute separate sources of funding for the pension plan, and underfunding is merely a component of the calculation of the employer contribution rates (what Mr. Lamoureux likened to constant course adjustments in sailing across the Bay).

The final source of funding for a plan is earnings on plan assets, which is consistent with the Court's understanding. Lamoureux Decl., ¶ 14. Therefore, the three sources of funding for the City's benefit obligations are member contributions, employer contributions, and plan earnings.

5. <u>The Ability of Participating Employers to Transfer Out of the CalPERS System.</u>

The Court has suggested that a participating employer like the City can move in and out of the System as a matter of normal course. Hr'g Tr. 29:2-13, July 8, 2014. This is not the case. There are legal and practical impediments to transferring plan assets and liabilities out of the System. For a city

like Stockton, the PERL currently permits only certain types of transfers out of CalPERS and then only to a 1937 Act County System. Cal. Gov. Code § 20585. Other transfer provisions under the PERL either apply only to specific pension systems or only when members transfer employment to a district or county service area.[12]

Plan transfers are extremely rare. Since 2000, there have been only two partial plan transfers out of CalPERS,[13] and both occurred under specific circumstances and involved a relatively small amount of funds. In both cases, the transfers were for only a specific group of members who transferred employment and consequently became participants in a different pension system. Both transfers consolidated accrued benefit obligations and associated assets in one system for all employees including the transferred members. *Id*. The two plan transfers since 2000 have been to the Los Angeles County Employees Retirement Association (LACERA) and to the San Francisco City and Country Employees' Retirement System (SFERS).[14] Each of these transfers was pursuant to the

[12]Section 20586 of the PERL governs the transfer of a portion of a participating employer's contract when the fire function and firefighters of such agency have been transferred to a district that participates in a 1937 Act County System. Section 20587 of the PERL governs the transfer of a portion of a participating employer's contract when a function and local members have been transferred to a district or a county service area that participates in a 1937 Act County System. Section 20588 governs transfers of a portion of a participating employer's contract from the State or a public agency to a 1937 Act County System in Kern, Los Angeles, and Orange counties when there has been a transfer of firefighting or law enforcement functions and employees to the county, fire authority, or district. Section 20589 governs transfers to the City and County of San Francisco County Employees' Retirement System with respect to certain safety members. Sections 20590 & 20591 govern certain transfers to the Los Angeles city retirement system. Section 20592 governs transfers in connection with the transfer of employment functions from a participating employer to an entity that does not participate in CalPERS.

[13]In 2002, 2004 (twice), 2008, 2011 and 2014 there were supplementary transfers of the assets and benefit obligations of particular members who would have been included in a prior LACERA transfer but had conditions (e.g., unresolved community property claim) that prevented their inclusion in the prior transfer.

[14] A copy of the Agreement for Transfer of Membership Benefits from CalPERS to LACERA is attached as Ex. A to CalPERS' Request for Judicial Notice in Support its Supplemental Brief in Support of Confirmation of the City of Stockton' First Amended Plan of Adjustment (the "Request for Judicial Notice"), filed contemporaneously herewith. A copy of the Agreement for Transfer of Membership Benefits from CalPERS to SFERS is attached as Ex. B to CalPERS' Request for Judicial Notice

California Legislature enacting specific legislation to amend the PERL and allow the transfers to occur.[15] *See* Cal. Gov. Code §§ 20588 and 20589.

When considering any request for a transfer, CalPERS must consider whether the transfer can be accomplished in a manner that protects the interests of the System. *See* Cal. Gov. Code §§ 20585(b), 20588(b), 20589(b), & 20590(b). CalPERS must determine the value of the assets to be transferred, the impact of the transfer on the member benefits, and whether members would be well served by the transfer. *See* CalPERS June 18, 2002 Agenda Item 4; CalPERS June 16, 2009 Agenda Item 4.[16] For example, in the case of the SFERS transfer, individual members were given the option to have their prior service under CalPERS transferred to SFERS, because some of the affected members may have been better off not transferring prior service. CalPERS June 16, 2009 Agenda Item 4.

CalPERS cannot reduce benefits in connection with a plan transfer and CalPERS would not agree to any transfer intended to reduce benefits post-transfer because such a transfer would not comport with CalPERS' policy requiring that members be well served by the transfer. *Id*. As discussed in more detail below in Section 6, benefit reduction is possible in the CalPERS system *only* following termination of a plan and assessment and non-payment of the termination liability. Hr'g Tr. 180:12-22, May 14, 2014. Once it terminates, the terminated agency is ineligible for a transfer pursuant to Cal. Gov. Code § 20585. As a result, it is not possible for Stockton to terminate, have benefits reduced by the CalPERS Board, and then transfer.

In any transfer out of CalPERS, the system accepting the transfer must consent to the transfer and agree to CalPERS' valuation of the assets to be transferred. CalPERS March 19, 2002 Agenda Item 7 (discussing issue of whether LACERA would agree with CalPERS valuation despite determining a different valuation).

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[15] Section 20590 of the PERL was originally enacted in 1976 and subsequently amended and repealed to permit various transfers to LACERA over the years.

[16] CalPERS March 19, 2002 Agenda Item 7 is attached to CalPERS' Request for Judicial Notice as Ex. C; CalPERS June 18, 2002 Agenda Item 4 is attached to CalPERS' Request for Judicial Notice as Ex. D; CalPERS June 16, 2009 Agenda Item 4 is attached to CalPERS' Request for Judicial Notice as Ex. E.

Under the current circumstances, the City does not appear to have a feasible transfer option. As stated above, under current law the City may permissibly transfer only to the County Plan. Cal. Gov. Code § 20585. It is not clear why the City would want to join the County Plan, which is much more underfunded than the City's plans with CalPERS. As a result, it appears that the City's payroll contribution costs would increase by approximately $8.4 million/year if it were to transfer to the County Plan.[17] It is also not clear why the County Plan would want to accept Stockton into its plan, given that Stockton would have failed to satisfy its obligations to CalPERS. Thus, it is quite likely the County Plan would not accept a transfer of the Stockton plans, leaving the City with no transfer options, other than petitioning the legislature for special legislation like that of SFERS and LACERA.

Finally, the current collective bargaining agreements do not allow a transfer. For example, the terms of the City's contracts with its police officers and firefighters require that the City participate in CalPERS specifically, not simply any retirement system generally, and to comply with State law in doing so. For example, the memorandum of understanding between the City and its fire department states that "[t]he City participates in the California Public Employees' Retirement System (PERS) and

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[17]Unlike CalPERS, where each City has separate plans, the County Plan appears to have a single plan for all covered employees. County Plan membership includes other local government organizations such as the Manteca-Lathrop Rural Fire District, Tracy Public Cemetery, San Joaquin County Mosquito Abatement District and the Waterloo-Morada Rural Fire District. *See* County Plan website, www.sjcera.org, "About SJCERA," (last visited August 7, 2014).

The County Plan has a single Actuarial Valuation for the plan that does not segregate out the assets and liabilities for each organization. *See* San Joaquin County Employees' Retirement Association Actuarial Valuation as of January 1, 2013, CalPERS' Request for Judicial Notice, Ex. F ("County Valuation"). The County Valuation shows that the County plan has a funded ratio on an actuarial valuation basis of only 63.4% as compared with comparable ratios for the City's miscellaneous plan of 88.5% and safety plan of 82.6%. *See* County Valuation, p. 3, Stockton Misc. Valuation, p. 6, Stockton Safety Valuation, p. 6 (Copies of the Actuarial Valuation as of June 30, 2012 for the Miscellaneous Plan for the City of Stockton ("Stockton Misc. Valuation") is attached Exhibit 7 to the Lamoureux Decl. and the Actuarial Valuation as of June 30, 2012 for the Safety Plan for the City of Stockton ("Stockton Safety Valuation") is attached as Exhibit 6 to the Lamoureux Decl.).

Because the funded ratio is much lower in the County Plan, the payroll contribution attributable to unfunded actuarial liability is much greater—it is 23.12% for the County plan as compared with approximately 15.07% for the combined Stockton plans. County Valuation, p. 3, Stockton Misc. Valuation, p. 6 (9.711% x $54,864,671 = $5,327,908), Stockton Safety Valuation, p. 6 (21.072% x $48,909,515 = $10,306,213) (($5,327,908 + $10,306,213)/($54,864,671 + $48,909,515) = 15.07%). Accordingly, the City's payroll contribution related to the unfunded actuarial liability in the County plan would be greater by approximately 8.05% (23.12 - 15.07), and its payroll cost would be increased by approximately $8,353,822 (8.05% x ($54,864,671 + $48,909,515)).

shall provide the Union's members hired on or before June 30, 2011 with the following retirement benefits ***in accordance with state law*** and the agreement between the City and PERS." Fire Unit Memorandum of Understanding, Term: July 1, 2014-June 30, 2015, section 13.1, http://www.stocktongov.com/files/ FireUnitMOU2014.pdf (last viewed August 11, 2014) (emphasis added). The memorandum of understanding between the City and the Stockton Police Officers Association states that "[t]he City will make application to P.E.R.S. to provide California Government Code section 20692 (Employer Paid Member Contributions Converted to Payrate during the Final Compensation Period) as an additional P.E.R.S. benefit, to be effective upon adoption by the Stockton City Council and the P.E.R.S. Administration Board." Memorandum of Understanding Between the Stockton Police Officers Association and City Of Stockton, Term: July 1, 2012- June 30, 2014, section 13.1 http://www.stocktongov.com/files/SPOAMOUFinalEff01July2012through30June2014.pdf (last viewed August 11, 2014).

6. Termination.

As set forth in the PERL, some circumstances allow for the termination of the relationship between a participating employer and CalPERS. There are two ways that a participating employer can end its participation in the System: (1) voluntarily by its own ordinance or resolution or (2) involuntarily by the CalPERS Board in the event of noncompliance or nonpayment. In the first case, contracts that have been in effect for at least five years can be terminated through approval of an ordinance or resolution of the participating employer's governing body, or through an ordinance adopted by the electorate, with one year's notice to CalPERS. Cal. Gov. Code §§ 20570 & 20571. Once CalPERS receives the initial notice of intent to terminate, it performs a preliminary termination calculation with a termination date one year from the effective date of the resolution to terminate. Hr'g Tr. 176:18-25, 177:1-2, May 14, 2014. Once the effective date of the termination occurs, CalPERS completes a final calculation based on final data. Hr'g Tr.177:11-25, 178:1, May 14, 2014.

An involuntary termination can occur if a participating employer fails to pay its required periodic contributions within 30 days after demand by the CalPERS Board, or fails to file any

information required in the administration of the System, or if the CalPERS Board determines the participating employer no longer exists. In these cases, the CalPERS Board may terminate the contract by resolution. Cal. Gov. Code § 20572; Hr'g Tr. 181:11-22, May 14, 2014.

In the event of termination, CalPERS assumes the actuarial risk of the terminated agency's member benefits. Hr'g Tr.178:16-18, May 14, 2014. Under the PERL, a terminated agency must make a payment to CalPERS in an amount determined by the CalPERS Board (based on actuarial calculations) to ensure payment of all pension benefits of the agency's employees accrued through the termination date into the future (the "Termination Payment"). Cal. Gov. Code § 20577. The Termination Payment is due immediately and subject to interest. *Id.* ("The amount of difference shall be subject to interest at the actuarial rate from the date of contract termination to the date the agency pays this system.") The Termination Payment, along with the terminated agency's existing plan assets, are paid into the "Terminated Agency Pool." Cal. Gov. Code § 20577.5. The Terminated Agency Pool ("TAP") is a pool administered solely for the benefit of members of terminated agencies. Hr'g Tr.182:17-183:7, May 14, 2014; Cal. Gov. Code § 20576. As of June 30, 2012, the TAP held approximately $178 million in assets and approximately $89 million in liabilities. Hr'g Tr.183:1-2.

In calculating the Termination Payment, CalPERS accounts for investment risk, mortality risk and wage fluctuation risk associated with the future payment of the terminated agency's members' benefits. Unlike in an ongoing plan, these risks cannot be addressed by adjusting contribution rates in future years. Because CalPERS cannot recoup any losses due to unrealized actuarial assumptions, the CalPERS Board must conservatively determine the Termination Payment and conservatively invest the assets of the TAP. Both the PERL and CalPERS' policies strive to protect the System from these risks when calculating the Termination Payment.[18] Cal. Gov. Code § 20576; *see also* Declaration of Michael B. Lubic in Support of CalPERS Brief In Support of the City of Stockton's Petition [Dkt. No. 712], Exhibit 11 (CalPERS Circular Letter No. 200-058-11 (August 19, 2011)),

[18]When a contracting agency terminates its relationship with the retirement system, the PERL specifically provides that the terminated agency is liable to CalPERS for the Termination Payment and costs of collection, including attorney's fees. Cal. Gov. Code § 20574.

Exhibit 12 (Aug. 2011 Agenda Item), Exhibit 13 (Dec. 2012 Agenda Item); Lamoureux Decl.¶ 39. However, no matter the protections created by the System, and no matter how sophisticated its actuarial calculations, a risk exists that the assets of the TAP will prove insufficient to fund the pension obligations to retirees.

If a terminated agency fails to pay in full the Termination Payment, CalPERS must take steps necessary to ensure the actuarial soundness of the TAP. If CalPERS determines that nonpayment will impact its ability to provide benefits to other members in the TAP, it must reduce benefits of the employees of the new terminated agency pro rata, based on the amount of the Termination Payment that remains unpaid.[19] Cal. Gov. Code § 20577& 20577.5; Hr'g Tr.180:12-22, May 14, 2014. This is, however, a one-time opportunity to reduce the benefits payable under the terminated contract; CalPERS gets no second chance to further reduce benefits if actuarial assumptions are not realized. *Id*; *see also* Hr'g Tr.182:12-14, May 14, 2014. The PERL permits no additional benefit reductions for accrued benefits, in any context.

If a city chooses to terminate its relationship with CalPERS, the city cannot enter into a new relationship with CalPERS for at least three years from the date of termination. Cal. Gov. Code § 20460. Although the city's existing employees who had benefits accrued as of the termination date in CalPERS would retain their benefits (albeit likely reduced dramatically if the Termination Payment is not made), they would earn no additional benefits, and new employees would not be able to participate in the System. Such a situation would undoubtedly impact the city's ability to retain and hire new employees and further impair its ability to provide essential services to its residents.

Throughout the termination process, CalPERS' actions are guided by its fiduciary responsibility to provide and protect the pension benefits of all the members and retirees, including those members and retirees who are members in the TAP or otherwise in the PERF. To suggest that CalPERS does not bear responsibility for any shortfall in payments is to ignore CalPERS' fiduciary responsibility to the System as a whole, as mandated by the PERL and the California Constitution.

[19]CalPERS may choose to make no reduction or a lesser reduction if the CalPERS Board has made reasonable efforts to the collect the payment and the CalPERS Board determines that failure to make a reduction will not impact the actuarial soundness of the TAP account. Cal. Gov. Code § 20577.5.

Members and retirees bear the financial risk of any payment shortfall to the extent their benefits are reduced following termination, but as discussed above with respect to the transfer of actuarial risk and below with respect to litigation risk, CalPERS also bears the risk of losses following termination and reduction of benefits.

i. Effect of Stockton Merger into the TAP.

As laid out in prior briefing and discussed at trial, if plans the size of the Stockton's plans are terminated and merged into the TAP without payment in full of the Termination Payment, at present valuation levels, such a merger would overwhelm and adversely affect the funded status of the TAP. Hr'g Tr.182:15-25, 183: 1-11, May 14, 2014. As of June 30, 2012, the TAP held approximately $178 million in assets and $89 million in benefit obligations, a surplus of approximately $89 million. Hr'g Tr.182:22-25, 183:1, May 14, 2014. In comparison, as of the same date, Stockton's plans' combined Termination Payment would be approximately $1.6 billion. Lamoureux Decl., ¶ 11. Thus, CalPERS could not realistically avoid imposing a benefit reduction if Stockton failed to pay in full its Termination Payment following termination of the Stockton plans.

A benefit reduction, although statutorily required if the conditions in Cal. Gov. Code § 20577.5 cannot be met, would not be without controversy and expense. Benefit reductions under § 20577 are anything but common practice. Since 2000, CalPERS has reduced benefits only once, in a unique circumstance where the contracting agency failed to ever report its payroll or make even one payment towards benefits for its members after it elected to join CalPERS. If CalPERS had to reduce benefits in Stockton's case, CalPERS faces the prospect of litigation brought by parties adversely affected by the reductions. The costs of defending such actions would be drawn from investment income derived from the System. Cal. Gov. Code § 20173. In turn, the System and other participating employers would be impacted by the administrative costs associated with responding to and defending such actions.

ii. Neither the City nor any other Party Has Identified a Viable Alternative to CalPERS.

As this Court noted, the City participates in CalPERS by virtue of the City's election to be bound by the PERL. Hr'g Tr.29:2-3, July 8, 2014. Although the City is not bound to remain in the

System, none of the theoretical alternatives identified by the Court—transfers to its own system, to a county system, or to a private pension provider—are viable for the City at this time. Tellingly, no party has ever submitted evidence in this case identifying a viable pension alternative to CalPERS. (Indeed, if there were a viable alternative, presumably the Capital Markets Creditors would have trumpeted this information during the eligibility fight or Franklin would have introduced such evidence at the confirmation hearing.) Moreover, there is no legal authority enabling the City to transfer its plan assets to a system other than the County Plan. If the City wished to create its own system and transfer its CalPERS plan assets to the City's system, it would have to obtain special legislation for that purpose. Without such legislation, a plan of adjustment providing for such a transfer could not be confirmed under Bankruptcy Code sections 943(b)(4) and (6). Finally, the City lacks sufficient resources to fund the implementation of its own pension system. City's Response to Supplemental Objection of Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund to Confirmation of First Amended Plan For the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1435], pp. 22-24. For all of these reasons, the Court has no basis to conclude that there is a viable alternative to CalPERS for the City.

7. <u>CalPERS' Termination Lien Is Not Avoidable in Bankruptcy.</u>

CalPERS reiterates its preference that the Court refrain from expressing an opinion on whether its termination can be avoided under chapter 5 of the Bankruptcy Code. However, if the Court expresses an opinion on the question of whether CalPERS' lien can be avoided in bankruptcy, it should conclude the lien cannot be avoided. CalPERS' lien on the assets of a terminated agency under Section 20574 is not avoidable under section 545 of the Bankruptcy Code. The plain language of the statute that creates the lien does not provide that the lien is triggered by the bankruptcy or insolvency of the City.

i. The CalPERS Lien Takes Effect When a Municipality Joins CalPERS.

Section 20574 of the PERL grants CalPERS "a lien on the assets of a terminated contracting agency, subject only to a prior lien for wages, in an amount equal to the actuarially determined deficit in funding for earned benefits of the employee members of the agency, interest, and collection costs.

The assets shall also be available to pay actual costs, including attorneys' fees, necessarily expended for collection of the lien." Cal. Gov. Code § 20574. The statute contains no language stating that the lien is triggered by the bankruptcy or insolvency of a contracting agency. The statute does not contain *any* triggering language. As discussed in detail below, given the lack of any triggering language in the statute, the most plausible reading is that CalPERS has a lien on the assets of a municipality as soon as the municipality joins CalPERS.

It is clear that one of the primary purposes of the statute is to ensure that the System is protected in the event of the bankruptcy of a contracting agency. Indeed, the legislative history contemplates that the lien is ***effective*** in bankruptcy. "The purpose [of the statute] is to secure the employees' retirement rights before the assets of the bankrupt agency are distributed to holders of materialmen and contractor's liens." A.B. 1648 Bill Analysis, Section 5. The statute cannot be interpreted in a manner contrary to this purpose. *Wirtz v. Bottle Blowers Ass'n*, 389 U.S. 463, 468 (1968) (stating that a "proper construction frequently requires consideration of [a statute's] wording against the background of its legislative history and in the light of the general objectives [the legislature] sought to achieve.") Reading the statute to mean that the lien is triggered upon the bankruptcy or insolvency of a contracting agency would run contrary to this purpose because a lien that would be triggered by the bankruptcy or insolvency of a contracting agency would be ineffective in bankruptcy pursuant to section 545(1) of the Bankruptcy Code, and the California Legislature would be presumed to know this.

Additional legislative history makes clear that the lien is not triggered by the bankruptcy or insolvency of a contracting agency. The statute is intended to grant a lien against "assets of public agencies who have terminated their membership in the system, ***usually*** as a result of agency dissolution and bankruptcy." Back-up Information on A.B. 1648, Section 4 (emphasis added). The history further states that the statute was enacted to address "[a] wide variety of fact situations," including dissolution, the transfer of functions to other agencies, and the consolidation of agencies. A.B. 1648 Bill Analysis, Section 5.

Moreover, the California Legislature intended that the lien arises ***immediately*** upon passage of the statute because the Chaptered Law contained an "urgency clause," which stated:

> This act is an urgency statute necessary for the immediate preservation of the public peace, health or safety within the meaning of Article IV of the [California] Constitution and shall go into immediate effect. The facts constitute necessity are: In the recent past, the Public Employees Retirement System has experienced a number of contracting agency terminations and reformations. In order that the protection afforded by this act to related members and beneficiaries may take effect ***at the earliest possible time***, it is necessary that this act take effect immediately.

A.B. 1648 (emphasis added). Under California law, such declarations of urgency carry great weight as to the legislative intent. *See, e.g.*, *People v. Camba*, 50 Cal. Rptr. 2d 907, 911 (1996).[20] As a result, the statute "follow[s] traditional wisdom that retirement contributions are, in reality, deferred compensation, by establishing a lien against agency assets second only to wages." A.B. 1648 Bill Analysis, Section 5. A lien arising only upon termination of a contracting agency would not satisfy the stated urgency of the California legislature. Taken together, these statements of legislative history confirm that upon passage of the statute, participation in CalPERS, not termination, bankruptcy or insolvency, is the event that triggers the lien.

ii. The CalPERS Lien is Not Avoidable Pursuant to Section 545 of the Bankruptcy Code Because it Is Not Triggered by the Bankruptcy or Insolvency of a Contracting Agency.

Applying section 545(1) of the Bankruptcy Code to the text of section 20574 of the PERL and its legislative history shows that the lien is not avoidable pursuant to section 545(1). Section 545(1) of the Bankruptcy Code allows a chapter 9 debtor to avoid a statutory lien that "first becomes effective against the debtor (A) when a case under this title concerning the debtor is commenced; . . . (D) when the debtor becomes insolvent; [or] (E) when the debtor's financial condition fails to meet a specified standard . . ." 11 U.S.C. § 545(1).

[20]Thus, this Court's suggestion that the California Legislature passed this law given concern about the newly revamped chapter 9 is not supported by the California's Legislature's statement of purpose. Hr'g Tr. 43:8-12, July 8, 2014.

"[S]ection 545(1) is not satisfied simply because a statutory lien attaches to the debtor's property when [it] is insolvent or after the occurrence of other events described in subsection (1). The requirement is met ***only if the lien arises (i.e., is made effective) because of (i.e., due to) the debtor's insolvency or the happening of any of the other described events***." *In re Swafford*, 160 B.R. 246, 248 (Bankr. N.D. Ga. 1993) (emphasis added) (citation omitted), *abrogated on other grounds by*, *In re McNeal*, 735 F.3d 1263 (11th Cir. 2012); *see also In re Howard*, 43 B.R. 135, 139 (Bankr. D. Md. 1983) ("The trustee may utilize the avoidance power contained in § 545(1)(D) only when the statute provides for creation of the lien upon the contingency of the debtor's insolvency [and the] lien is unavoidable under § 545(1)(E) because the [] lien statute does not require the debtor to meet a specified financial standard.") (citation omitted).

As discussed above, nothing in the statute or legislative history of section 20574 indicates that the lien is triggered by either the commencement of a chapter 9 case or the insolvency or financial condition of the debtor. Reading such requirement into the statute would run contrary to the stated purpose of the legislature in passing the statute. The event that triggers the lien is a contracting agency's participation in the CalPERS system. Thus, based on the language of section 545(1) and its accompanying case law, a lien arising under section 20574 of the PERL is not be avoidable under section 545(1) of the Bankruptcy Code. Even if the statute were to be read to be triggered upon the termination of a municipality's relationship with CalPERS, nothing in the statute or legislative history makes termination dependent on bankruptcy or insolvency and, thus, section 545(1) still does not apply.[21]

[21]The lien statute here can be contrasted with other lien statutes which have requirements for perfection and thus can be avoided under section 545(2) if such requirements are not satisfied. *E.g.*, *In re Pierce*, 809 F.2d 1356, 1360 (8th Cir. 1987) (holding that attorneys' lien could be avoided under section 545(2) because under Minnesota law, "notice of a lien must be filed by the attorney in order for the lien to be effective against third parties."); *In re Cutty's-Gurnee, Inc.*, 133 B.R. 929, 932 (Bankr. N.D. Ill. 1991) (holding that mechanic's lien was avoidable under section 545(2) because claimant "had not perfected its lien [by filing suit] within the four month period required by" Illinois law); *In re McDonald*, 163 F. Supp. 951, 952 (E.D.N.Y. 1958) (holding that materialman's lien could be avoided under predecessor to section 545(2) because "creditor failed to meet the basic requirement of the statute in that he never filed a notice of lien."); *see also* Cal. Civ. Code § 8460 (stating that a mechanic's lien is valid under California law only if the "claimant . . . commence[s] an action to enforce a lien within 90 days after recordation of the claim of lien.") As discussed above, section 20574 of PERL is automatically perfected and does not set forth any perfection requirements. These

B. The City's Relationship with CalPERS Cannot be Rejected In Bankruptcy.

Again, CalPERS reiterates its preference that the Court refrain from expressing an opinion on the applicability of section 365 of the Bankruptcy Code to the CalPERS relationship. However, if the Court decides the question of whether the City's relationship with CalPERS may be rejected in bankruptcy, it should conclude that rejection of the CalPERS relationship is impossible. The City's relationship with CalPERS does not constitute an executory contract that is subject to rejection in bankruptcy. Moreover, section 20487 of the California Government Code, expressly prohibits rejection and forms part of the State's consent to the City's chapter 9. As a result, if the City ever attempts to reject its relationship with CalPERS, the City would become ineligible for relief under chapter 9.

1. A City's Relationship with CalPERS Does Not Constitute an Executory Contract.

A municipality's relationship with CalPERS does not constitute an executory contract within the meaning of section 365 of the Bankruptcy Code. The "contract" is not really a contract at all, but is instead primarily a statutory relationship, in particular as it relates to a city's obligations to continue to participate in the System. The "contract" is not of the same character as a commercial contract; rather it is an election into a statutory system of deferred compensation. *Jasper*, 164 Cal. App. 2d at 675 (1958). The PERL details the circumstances under which the relationship between an employer and CalPERS can be terminated and expressly prohibits rejection of any contract or agreement between a chapter 9 debtor and CalPERS outside of the termination provisions of the PERL. Cal. Gov. Code § 20487. Because a city's obligations to CalPERS are governed primarily by applicable State law and regulations, a city's relationship cannot be construed as a contract which can be treated under section 365 of the Bankruptcy Code.

Even if the relationship between a city and CalPERS was determined to be a contract, it is not an executory contract under Section 365 of the Bankruptcy Code. Under the "Countryman" definition

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mechanics' and attorneys' liens are the kinds of unperfected liens that § 545 are meant to avoid, not liens like the one held by CalPERS.

of executory contracts employed by the Ninth Circuit, executory contracts are contracts where performance is due by both sides *and* where "the obligations of both parties are so far unperformed that the failure of either party to complete performance ***would constitute a material breach and thus excuse performance of the other***." *Marcus & Millichap Inc. v. Munple, Ltd (In re Munple)*, 868 F.2d 1129, 1130 (9th Cir. 1989) (emphasis added). In determining whether a contract is executory therefore, courts must determine whether "either party's failure to perform its remaining obligations would give rise to a material breach and excuse performance." *In re Texscan Corp.*, 976 F.2d 1269, 1272 (9th Cir. 1992). In *Texscan*, the debtor sought to reject an insurance premium contract. The Ninth Circuit held that while the debtor and its insurer had reciprocal obligations under the agreement, the contract was not executory because an Arizona state statute prohibited the insurer "from stopping performance, despite Texscan's inability to perform its obligation." *Id.* at 1273.

Here, CalPERS has a statutory duty under State law to administer pension benefits for members and retirees even in the event that a city fails to make its statutorily required contribution payments.[22] Even if a city attempts to reject the relationship, CalPERS must continue to, for example, invest the assets of the pension plans and pay benefits to retirees of the city. As was the case in *Texscan*, State law prohibits the nondebtor party, CalPERS, from failing to perform. Thus, a city's relationship with CalPERS, even if it were contractual in nature, is not an executory contract subject to rejection under the Bankruptcy Code.

2. Section 20487 of the PERL Expressly Prohibits Rejection.

The PERL provides that "[n]otwithstanding any other provision of law, no contracting agency or public agency that becomes the subject of a case under the bankruptcy provisions of chapter 9 . . . shall reject any contract or agreement between that agency and the board pursuant to Section 365 [of the Bankruptcy Code] or any similar provision of law . . . ." Cal. Gov. Code § 20487. Any attempt by the City to reject its relationship with CalPERS through the City's bankruptcy would therefore violate State law. In enacting the section 20487, California has expressly chosen to control its municipalities

[22]Note that, in the San Bernardino bankruptcy case, the city failed to make its employer contributions for an entire year following its bankruptcy filing, yet CalPERS continued to pay benefits without interruption or reduction.

in chapter 9. As explained in the Constitutional Brief, section 903 of the Code protects the statute from preemption and makes it clear that the State's control over a municipality, through section 20487, is not lost merely because such municipality is in bankruptcy. Even ignoring the effect of section 903, Congress did not intend for the Code to preempt State laws like section 20487. In CalPERS' Constitutional Brief, CalPERS sets forth in detail why no such Congressional intent to preempt can be found and why the presumption against preemption cannot be overcome with respect to section 20487.

3. Rejection Would Render a City Ineligible for Relief under Chapter 9.

Section 20487 is part of the State's "consent" to a municipality's chapter 9 filing. As argued in greater detail in CalPERS' Constitutional Brief, the statute is a specific limitation that the State has placed on its political subdivisions' entry into chapter 9. Absent state consent, the Tenth Amendment bars a municipality from filing for bankruptcy.[23] Thus, were a city to attempt to reject its relationship with CalPERS, it would violate a specific condition the State has placed on its consent to a city's chapter 9 filing and, as a result, the city would no longer be eligible for relief in chapter 9.

C. Justiciability Doctrines Prevent this Court from Deciding Whether Pensions Can Be Impaired Under a Hypothetical Plan Proposed by a Hypothetical Debtor.

CalPERS has consistently requested that the Court refrain from deciding hypothetical issues regarding pension impairment in chapter 9 or the enforceability of provisions of the PERL under a hypothetical chapter 9 case. The Court should not decide these issues because they are not presently justiciable under the circumstances of this case.

Under Article III, Section 2 of the United States Constitution, federal jurisdiction is limited to actual "cases" or "controversies," *Allen v. Wright*, 468 U.S. 737, 750 (1984); and Article III applies in bankruptcy courts. *In re Res. Tech. Corp.*, 624 F.3d 376, 382 (7th Cir. 2010). Justiciability is a threshold question that *must* be resolved in every federal proceeding before any party can claim relief. *City of Los Angeles v. Kern*, 581 F.3d 841, 845 (9th Cir. 2009) ("These limits are

[23] A state's control over its political subdivisions is so strong that the legislative history of chapter 9 indicates that "withdrawal of State consent at ***any time*** will terminate the case[.]" H.R. REP. NO. 94-686, at 8, *reprinted in* 1976 U.S.C.C.A.N. 539, 545 (emphasis added).

jurisdictional: they cannot be waived by any party, and there is no question that a court can, and indeed must, resolve any doubts about this constitutional issue sua sponte."). Thus, this Court has an independent obligation to determine whether any party has, for example, Article III standing to challenge California Government Code sections 20487 and 20574, or whether any challenges to those laws are constitutionally ripe.

There are several constitutionally-based bars to this Court opining on the constitutionality of California statutes or on the question of pension impairment in general. *First*, no party has standing to challenge any of the California laws that this Court has suggested may be at issue or the issues of impairment of pensions in general. *Second*, whether or not certain California laws are or are not constitutional (*i.e.*, not preempted) is not ripe for adjudication. *Third*, even if any party could satisfy the requirements of Article III, the longstanding prohibition against the issuance of advisory opinions and the doctrine of avoiding constitutional questions mandates that this Court refrain from issuing any ruling on the constitutionality of any California laws or whether pensions can be impaired consistent with section 903 and the Tenth Amendment.[24]

Further, the applicable confirmation requirements in this case do not give the Court a basis to rule regarding CalPERS' relationship with the City. This Court does not have a legal basis to evaluate whether the plan is fair and equitable to, and does not discriminate unfairly against, Franklin. Section 1129(b)'s "unfair discrimination" and "fair and equitable" tests only apply "to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b). Franklin's unsecured claims are in Class 12 of the Plan, which has voted to accept the plan. Declaration of Catherine Nownes-Whitaker Regarding Tabulation of Ballot Vote Accept or Reject First Amended Plan of Adjustment, p. 5 [Dkt. No. 1268]. Thus, Franklin cannot argue that the City's Plan fails to meet the "unfair discrimination" and "fair and equitable" tests set forth in section 1129(b) of the Bankruptcy Code with respect to Franklin's treatment under the Plan.

[24]CalPERS separately provides the Constitutional Brief, which provides briefing on the substantive constitutional, statutory and preemption principles relevant to any decision regarding a potential adjustment or impairment of CalPERS interests in chapter 9 to the extent that the Court remains convinced that it must opine about those questions.

The only applicable standard with respect to the treatment of Franklin is whether "the plan is in the best interests of creditors . . . ." 11 U.S.C.§ 943(b)(7). The best interests test serves "as a 'floor requiring a reasonable effort at payment of creditors by the municipal debtor." *In re Pierce Cnty. Hous. Auth*, 414 B.R. 702, 718 (B. W.D. Wash. 2009) (quoting *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 34 (Bankr. D. Colo. 1999). Under the best interests test, the court is "simply require[d] . . . to make a determination of whether or not the plan as proposed is better than the alternatives." *In re Sanitary & Improvement Dist. No. 7*, 98 B.R. 970, 974 (Bankr. D. Neb. 1989). In a chapter 9 case, because "creditors cannot propose a plan; cannot convert to Chapter 7; cannot have a trustee appointed; and cannot force a sale of municipal assets under state law, their only alternative to a debtor's plan is dismissal." *Mount Carbon*, 242 B.R. at 34.

Thus, the Bankruptcy Code neither permits nor allows the Court to consider hypothetical alternative plan treatments when deciding whether to confirm the City's Plan. Further, dismissing the case would not benefit Franklin. If the City were to terminate its relationship with CalPERS, the resulting secured termination claim of approximately $1.6 billion would swamp all other claims, including Franklin's, and, given the City's limited resources, any payment to Franklin would likely be no better, and likely worse, than under the Plan.

In practical terms, any decision on the question of the impairment of pensions has the potential to impact the State of California as a whole. Current employees rely on their pensions to plan for the future and retirees rely on pensions to survive. Pensions secure financial futures and help the State and its local subdivisions recruit and retain valuable public servants. Putting a cloud over public pensions only invites worry and uncertainty about the security of those pensions. The practical implications of rendering a decision regarding the intersection of chapter 9 and public pensions counsels against making decisions in the abstract. Because the City's Plan is not predicated on an impairment of pensions, and because there is no evidence regarding a feasible alternate plan or the cost of such plan, CalPERS respectfully requests that this Court refrain from making any comments or decisions on the matter.

If the Court concludes that, in order to apply the best interests test, it must consider hypothetical alternate plans, the Court would not merely need to determine that pensions can be modified, but it *would also have to determine whether modification of pensions would result in a higher payment to Franklin*. In order to do that, the Court would need to look at the costs related to alternatives to CalPERS and determine that there is an alternative that would allow the City to attract employees at a lower expense than CalPERS. There is no evidence before the Court that would allow it to make such a determination. Further, the Court would need to determine the effect on recruiting and retention of any modification of pensions (in other words, once the City modifies pensions, it may have difficulty attracting and retaining employees because, having modified pensions once, employees may fear their pensions could be modified again). Again, there is no evidence before the Court to make such a determination.

1. No Party Can Establish Standing.

To establish Article III standing, a "litigant must prove that [1] he has suffered a concrete and particularized injury [2] that is fairly traceable to the challenged conduct, [3] and is likely to be redressed by a favorable judicial decision." *Hollingsworth v. Perry*, 133 S. Ct. 2652, 2661 (2013) (citing *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61 (1992)); *see also DaimlerChrysler Corp. v. Cuno*, 547 U.S. 332, 341 (2006) ("If a dispute is not a proper case or controversy, the courts have no business deciding it, or expounding on the law in the course of doing so."). Article III standing must be present at every stage of the litigation, *Hollingsworth*, 133 S. Ct. at 2661, and the burden of establishing standing rests with either the City or Franklin. *Cuno*, 547 U.S. at 342.

Injury in Fact. "The injury in fact must constitute an invasion of a legally protected interest which is (a) concrete and particularized, and (b) actual or imminent, not conjectural or hypothetical." *Lopez v. Candaele*, 630 F.3d 775, 785 (9th Cir. 2010) (quotations omitted). Generalized grievances will not suffice. *Hollingsworth*, 133 S. Ct. at 2662.[25] No party in this case can establish an injury in

[25]This Court has suggested that it needs to scrutinize the City's plan even more so than under other chapters of the Code because there are numerous other interests that are not before this Court. Hr'g Tr. 169:10-170:13, May 12, 2014. This view is unsupported by any language in the Code and is akin to a "generalized grievance" on behalf of all non-represented citizens of Stockton in this case. Thus, if a *party* were to make this claim, it would be clear under established Supreme Court precedent that standing would not exist. *See, e.g.*, *Lujan*, 504 U.S. at 573-74 ("A litigant raising only a generally

fact sufficient to satisfy Article III as a basis to challenge the validity of certain provisions of the PERL.

With respect to the City, it is clear it does not have any injury in fact because the City has maintained all along that it has no intention of impairing its relationship with CalPERS. There is no evidence suggesting, let alone establishing, that Stockton chose not to impair its relationship with CalPERS because Stockton lacked the authority to do so under section 20487 or because it believed section 20574 created an enforceable lien. Rather, the City has been steadfast in its position: impairing its relationship with CalPERS would be catastrophic to the City's economic recovery because it would cause a mass exodus of qualified police and other employees essential to the City's successful reorganization. As counsel for the City said during Closing Arguments, the decision not to impair pensions rests on "the City's concern [ ] about its current employees and retaining its current employees and retaining a City that people will want to live in." Hr'g Tr. 220:22-24, June 4, 2014. The City has never claimed an injury in fact regarding enforceability of the PERL or hypothetical pension impairment in chapter 9 sufficient to satisfy Article III's standing requirements.

Franklin cannot demonstrate any injury in fact for Article III purposes either. Any claimed injury caused by the application of California laws, section 903 or the Tenth Amendment, would be purely hypothetical and conjectural unless and until the City takes the position that it is not impairing CalPERS *because* it is legally precluded from doing so. Even then, Franklin would lack standing to challenge the propriety of sections 20487 and 20574 of the PERL unless and until CalPERS invoked either statute. Until that point, those statutes are not at issue in this case and Franklin has not suffered any injury in fact.

In addition, it is no answer to say that because Franklin has standing to challenge the City's plan, which has not proposed to impair pensions, that Franklin also has standing to raise the issue of whether section 20487 is preempted or whether section 20574 creates a valid lien. As the Supreme Court recognized: "our standing cases confirm that a plaintiff must demonstrate standing for each

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available grievance about government—claiming only harm to his and every citizen's interest in proper application and laws, and seeking relief that no more directly and tangibly benefits him that it does the public at large—does not state an Article III case or controversy.")

claim he seeks to press." *Cuno*, 547 U.S. at 352 (citing cases). In other words, Franklin would need to show it has been injured by sections 20487 or 20574. This it obviously cannot do given that the City has not invoked either of those statutes as the reason for why it made the sound business decision not to disturb its long-standing relationship with CalPERS.

Fairly Traceable and Redressable. Even if Franklin could satisfy the injury in fact requirement,[26] any claim of injury (*i.e.*, not enough money for Franklin) is not fairly traceable to any California statute or to pension impairment in general. Likewise, Franklin could not show that a ruling in its favor would redress its claimed injury.

It is pure speculation to assume that, if this Court determined that certain California statutes were unconstitutional and that the City could impair its obligations to CalPERS, that the City would actually propose a plan seeking to impair CalPERS. Thus, these factors are not met. *See, e.g.*, *Clapper v. Amnesty Int'l USA*, 133 S. Ct. 1138, 1148-1149 (2013) at 1148-49 (rejecting speculative theory of traceability); *see also Worth v. Seldin*, 422 U.S. 490, 505-06 (1975); *Simon v. E. Ky. Welfare Rights Org.*, 426 U.S. 26, 45-46 (1976). Indeed, there is no evidence in this record, and no specific facts alleged, to prove that the City's decision not to impair pensions rested on anything but a concern relating to the ability of the City to retain and recruit valuable public servants. Any suggestion that the City has somehow failed to "take on" pensions because of various California statutes or the Tenth Amendment is not supported by the record. Thus, Franklin cannot satisfy the requirement of proving an injury in fact to establish Article III standing.

2. Ripeness Does Not Exist.

"A claim is not ripe for adjudication if it rests upon contingent future events that may not occur as anticipated, or indeed may not occur at all." *Texas v. United States*, 523 U.S. 296, 300 (1998) (quotation omitted). "[R]ipeness is peculiarly a question of timing, designed to prevent the courts, through avoidance of premature adjudication, from entangling themselves in abstract disagreements." *Thomas v. Anchorage Equal Rights Comm'n*, 220 F.3d 1134, 1138 (9th Cir. 2000)

[26]By not including the City in this portion of the argument, CalPERS does not concede that the City could establish either of these constitutional requirements for Article III standing under the current facts and circumstances.

(en banc) (quotations & citations omitted). Ripeness "is drawn both from Article III limitations on judicial power and from prudential reasons for refusing to exercise jurisdiction." *Reno v. Catholic Soc. Servs., Inc.*, 509 U.S. 43, 57 n.18 (1993). Here, no party can claim the "CalPERS issues" are constitutionally ripe.

In assessing the constitutional component of ripeness, courts must consider three factors: (1) whether the party challenging a law faces "a realistic danger of sustaining direct injury as result of the statute's operation or enforcement;" (2) whether there is a specific threat of enforcement of the challenged law; and, (3) the history of the enforcement of the law in question. *Thomas*, 220 F.3d at 1139-41. In applying these three factors to a challenge to two laws that prohibited rental discrimination on the basis of marital status, the Ninth Circuit concluded that the challenge was not ripe because:

> Considering the applicable factors, we hold that any threat of enforcement or prosecution against the landlords in this case—though theoretically possible—is not reasonable or imminent. The asserted threat is wholly contingent upon the occurrence of unforeseeable events: whether the landlords retain their rental properties; whether an unmarried couple will seek to lease available property; whether the couple, having been denied tenancy, will file a complaint or communicate the alleged discrimination to the enforcement agencies; and whether the enforcement agencies will decide to prosecute. The landlords do not at this time confront a realistic danger of sustaining a direct injury as a result of the statute's operation or enforcement, and thus this dispute is not justiciable, because it is not ripe for court review.

Id. at 1141 (citations & quotations omitted). Like the landlords' challenge in *Thomas*, the issue of whether certain California laws are constitutional under the Supremacy Clause or whether pensions can be impaired generally or whether specific provisions of the PERL are enforceable in a hypothetical chapter 9 case is not constitutionally ripe because that conclusion necessarily rests on a series of unsupported premises.

No party can show any threat of enforcement of the statutes at issue, given the City has not proposed any plan seeking to impair CalPERS, nor has the City sought to terminate its relationship with CalPERS. As such, neither of the California laws in question has actually been invoked. Thus, while it remains a theoretical possibility that those laws may be invoked in the future, such a possibility is insufficient to establish constitutional ripeness. Like the landlords' challenge in *Thomas*, any concern on the part of Franklin (or this Court or the City) about the invocation of these California

laws is based "upon the occurrence of unforeseeable events;" namely, what the City would actually do if the Court sent the City back to the drawing board. Finally, no party can claim any "realistic danger" by virtue of these California laws being on the books because given the facts and circumstances of this case, CalPERS has not affirmatively invoked the California law prohibiting rejection nor has it asserted any statutory lien. The reason for this is simple: neither of those laws is truly at issue in this case.

Even if the Court were to conclude the claims were constitutionally ripe, the "CalPERS issues" are not constitutionally ripe because of prudential reasons. In assessing the prudential components of ripeness, courts are "guided by two overarching considerations: 'the fitness of the issues for judicial decision and the hardship to the parties of withholding court consideration.'" *Thomas*, 220 F.3d at 1141 (quoting *Abbott Laboratories v. Gardner*, 387 U.S. 136, 149 (1967)). In noting that it would "decline to exercise jurisdiction under the prudential component of the ripeness doctrine," the Ninth Circuit noted that "[a] concrete factual situation is necessary to delineate the boundaries of what conduct the government may or may not regulate." *Thomas*, 220 F.3d at 1141 (quotation omitted). In so holding, the *en banc* court noted: "This case is a classic one for invoking the maxim that we do not decide 'constitutional questions in a vacuum.'" *Id.* (citing *American-Arab Anti-Discrimination Comm. v. Thornburgh*, 970 F.2d 501, 511 (9th Cir. 1992) (quoting *W.E.B. DuBois Clubs of America v. Clark*, 389 U.S. 309, 312 (1967) (per curiam)).

Here, the City has not proposed a plan seeking to impair CalPERS. Consequently, no "concrete factual situation" exists. For example, the City has not proposed a plan terminating its relationship with CalPERS and further proposing to pay CalPERS anything short of the full termination payment required by California law. Moreover, whether a creature of the State of California can, in a manner consistent with section 903 and the Tenth Amendment, use the federal courts to ignore applicable State laws is an important constitutional question that, as both the Supreme Court and the Ninth Circuit have recognized, should not be decided "in a vacuum." Accordingly, these issues are not fit for review. *See, e.g.*, *Texas*, 523 U.S. at 300 (issues not fit for

resolution because "operation of the statute is better grasped when viewed in light of a particular application.").

Likewise, with respect to the hardship to the parties, this factor also cuts in favor of not deciding the "CalPERS issues." If any party were to suffer hardship here it would be CalPERS because, it is "being forced to defend [California's laws, section 903 and the Tenth Amendment] in a vacuum." *Thomas*, 220 F.3d at 1142. For these reasons, the "CalPERS issues" are not constitutionally ripe, and even if they were, this Court should follow the Supreme Court's and the Ninth Circuit's lead and invoke the prudential component of ripeness and refrain from deciding these issues.

3. <u>This Court Should Not Issue Advisory Opinions and Should Avoid Constitutional Questions.</u>

Federal courts lack the power under Article III to issue advisory opinions, and this prohibition is as old as the Judiciary itself. *Case of Hayburn*, 2 U.S. 408 (1792); *Flast v. Cohen*, 392 U.S. 83, 97 n.14 (1968).[27] The "'judicial Power' is one to render dispositive judgments," not advisory opinions. *Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211, 219 (1995) (quotations omitted); *see also California v. San Pablo & Tulare R.R. Co.*, 149 U.S. 308, 314 (1893) ("The court is not empowered to decide . . . abstract propositions."). As the *en banc* Ninth Circuit noted: "Our role is neither to issue advisory opinions nor to declare rights in hypothetical cases, but to adjudicate live cases or controversies consistent with the powers granted the judiciary in Article III of the Constitution." *Thomas*, 220 F.3d at 1139 (9th Cir. 2000) (en banc).

The prohibition against the issuance of advisory opinions takes on special force when the constitutionality of a statute comes into play. There are several interrelated, yet independent, considerations that fall under the rubric of constitutional avoidance. Justice Brandeis famously explained these considerations in his concurring opinion in *Ashwander v. TVA*, 297 U.S. 288, 346-47 (1936) (Brandeis, J., concurring). A few bear emphasis: (1) courts should not anticipate constitutional questions and should only decide such questions when "absolutely necessary;" (2) courts must "pass upon a constitutional question" if there is "some other ground upon which the case

[27] CalPERS has provided briefing on these issues to the Court in the Constitutional Brief.

may be disposed of;" and (3) "it is a cardinal principle" that courts must construe statutes in a manner to avoid, not confront, constitutional questions. *Id.* (internal quotations & citations omitted).

Just last Term, the Court reaffirmed this principle: "[I]t is a well established principle governing the prudent exercise of this Court's jurisdiction that normally the Court will not decide a constitutional question if there is some other grounds upon which to dispose the case." *Bond v. United States*, 134 S. Ct. 2077, 2087 (2014) (hereinafter "*Bond II*") (citations omitted). Applying these principles, it becomes apparent that deciding various issues relating to pensions is not, in the terminology of the Supreme Court, "absolutely necessary" and, therefore, CalPERS respectfully asks this Court to refrain from rendering any opinion on these issues.

The Supreme Court's decision in *United Student Aid Funds, Inc. v. Espinosa*, 559 U.S. 260 (2010), does not require a different result. In *Espinosa*, the issue before the Court was "whether an order that confirms the discharge of a student loan debt in the absence of an undue hardship finding or an adversary proceeding, or both, is a void judgment for [Fed. Rule Civ. P.] 60(b) purposes." 559 U.S. at 264. The Court addressed whether the Ninth Circuit was correct in its conclusion that a chapter 13 plan should be confirmed "despite its failure to comply with the Code and [Bankruptcy] Rules." *Id.* at 276-278. The Court said the Ninth Circuit took "a step too far" in concluding that "bankruptcy courts *must* confirm a plan proposing the discharge of a student loan debt without a determination of undue hardship in an adversary proceeding unless the creditor timely raises a specific objection." *Id.* at 276 (emphasis in original).

In so concluding, the Court looked to the language of 11 U.S.C. § 1325(a)(1), which "instructs a bankruptcy court to confirm a plan only if the court finds, inter alia, that the plan complies with the applicable provisions of the Code." *Espinosa*, 559 U.S. at 277 (quotations omitted). Specifically, the Court concluded that "the Code makes plain that bankruptcy courts have the authority—indeed, the obligation—to direct a debtor to conform his plan to the requirements of §§ 1328(a)(2)523(a)(8) [of the Bankruptcy Code]." *Id.* In a footnote, the Court noted that section 1325(a) "*requires* bankruptcy courts to address and correct a defect in a debtor's proposed plan even if no creditor raises the issue." *Id.* at 277 n.14 (emphasis in original).

Although *Espinosa* merely confirmed that bankruptcy courts have an independent obligation to ensure compliance with the Code, nothing in that opinion suggests, let alone requires, that bankruptcy courts must decide all issues that may or may not be raised by the parties. *Espinosa* does not require bankruptcy courts to decide issues (especially those of a constitutional nature) that are not absolutely necessary to the determination of whether a plan meets the requirements of the Code. Moreover, *Espinosa* involved a chapter 13 case. While there is an analogue to section 1325(a)(1) which is applicable in chapter 9, [28] there is no analogue in chapter 13 to section 903, which limits the jurisdiction and powers of a bankruptcy court in chapter 9 case.

This Court has suggested there are three possible ways the Court could rule regarding the CalPERS contract in the context of plan confirmation. Hr'g Tr. 174:6-175:3, May 13, 2014. Mirroring these, CalPERS respectfully sees six possibilities:

1. The CalPERS relationship can be impaired and the City's Plan fails to meet the confirmation standards set forth in the Code because the City failed to take that into account; or,
2. The CalPERS relationship can be impaired, but given the evidence, the City's Plan can be confirmed because it meets the confirmation standards set forth in the Code; or,
3. The CalPERS relationship cannot be impaired, either because Federal or State law (or both) does not allow such impairment, and the City's Plan can be confirmed because it meets the confirmation standards set forth in the Code; or,
4. The CalPERS relationship cannot be impaired, either because Federal or State law (or both) does not allow such impairment, but the City's Plan cannot be confirmed because it fails to meet the confirmation standards set forth in the Code; or,
5. It does not matter whether or not the CalPERS relationship can be impaired because the City's Plan meets the confirmation standards set forth in the Code; or,
6. It does not matter whether or not the CalPERS relationship can be impaired because the City's Plan does not meet the confirmation standards set forth in the Code.

Under none of these scenarios, however, are the questions related to who CalPERS is or whether or not it can be impaired "absolutely necessary" to determine whether the City's Plan complies with the Bankruptcy Code's confirmation requirement. With respect to Nos. 5 and 6, the

[28] Section 1129(a)(1) states that "[t]he court shall confirm a plan only if all of the following requirements are met: (1) The plan complies with the applicable provisions of this title." 11 U.S.C. § 1129(a)(1).

lack of necessity of answering these questions is self-evident. With respect to Nos. 3 and 4, the same is true. While CalPERS believes that No. 3 is the correct result in this case, it is not asking this Court to issue *any* ruling, whether supportive of CalPERS position or not, with respect to pensions and all of the issues that are tied to that conclusion. Either way, this Court would be issuing an unnecessary advisory opinion on these issues.

With respect to No. 2, if this Court confirms the City's plan because it meets the requirements of the Bankruptcy Code, nothing more needs to be said regarding CalPERS. The questions regarding pension impairment become moot because the predicate question of whether or not pensions can be impaired, and all of the ancillary issues associated with that question (traditional state function, creditor status, preemption, etc.), are no longer germane to the ultimate issue in this case. Either the City's Plan meets the requirements of the Bankruptcy Code, or it does not. This is the only issue before this Court and this is particularly so if this Court determines the City's Plan is confirmable under the Bankruptcy Code.

The same is true with respect to No. 1. Even if this Court is going to determine that the City's plan does not meet the requirements of the Bankruptcy Code, it still does not have to opine on any of these issues. Unless, of course, this Court is prepared to rule that the *only plan the City can ever confirm is one that impairs CalPERS*,[29] the "CalPERS issues" are not, as Justice Brandeis said, "absolutely necessary" to the determination of whether the City's Plan meets the requirements of the Bankruptcy Code.[30] This is so because the City has never taken the position that it cannot legally impair pensions and that position has not formed the basis of its Plan. Had the City made such a claim, perhaps the result would be different under the "good faith" analysis because it would explain why the City chose to propose a plan that does not impair CalPERS. The evidence, however, does not

[29]The problem with considering alternate plans is that there are an infinite number of hypothetical plans. For example, see "Bankrupt San Bernardino looks at marijuana sales to raise funds," http://www.reuters.com/article/2014/07/30/us-usa-municipalty-sanbernardino-idUSKBN0FZ2IR20140730 (last visited August 10, 2014).

[30]Such a conclusion, however, is contrary to 11 U.S.C. § 904 because it would be telling the City how to spend its money, which § 904 prohibits. As one court explained, a court's control over a municipal debtor is "strictly limited to disapproving or to approving and carrying out a proposed composition." *Leco Props. v. R.E. Crummer & Co.*, 128 F.2d 110, 113 (5th Cir. 1942). The power to confirm a plan does not provide the Court with the concomitant power to propose, or even suggest, an alternate plan.

support this. Rather, the City's decision is based solely on its concerns regarding retaining and recruiting public employees. There is ample evidence to support the City's reasons for retaining its valuable pension benefits system.

Even if this Court believes that the predicate decision of pension impairment is absolutely necessary and unavoidable, it can do what the Supreme Court does routinely: Assume without actually deciding the predicate. *See, e.g., Executive Benefits Ins. v. Arkison*, 134 S. Ct. 2165, 2174 (2014) ("we assume without deciding, that the fraudulent conveyance claims in this case are *Stern* claims."); *Wood v. Moss*, 134 S. Ct. 2056, 2066 (2014) ("we have several times assumed without deciding that *Bivens* extends to First Amendment claims. We do so again in this case.") (citations omitted); *Lexmark Intern., Inc. v. Static Control Components, Inc.*, 134 S. Ct. 1377, 1385 n. 1; *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1759 (2013); *NASA v. Nelson*, 131 S. Ct. 746, 751 (2011) ("We assume, without deciding, that the Constitution protects a privacy right[.]"). The Ninth Circuit recently did just this in order to avoid resolving a "potentially far-reaching question." *United States v. Gowadia*, -- F.3d --, 2014 WL 3702583, at *6 (9th Cir. July 28, 2014). Thus, if this Court believes that any issue related to CalPERS is a necessary predicate to any of the Court's conclusions, it should assume without deciding that CalPERS can or cannot be impaired. Doing so is consistent with a substantial body of Supreme Court jurisprudence that instructs courts to avoid deciding important questions unless doing so is unavoidable.

It may very well be that in a future case, with a different debtor, the issue of whether a California municipal debtor can impair its relationship with CalPERS will actually blossom into a contested matter that absolutely must be decided. This case, however, is not that case.

III. CONCLUSION

In addressing the specific questions the Court directed the parties to present, CalPERS is not akin to a private pension provider. Rather, it is an agency of the State exercising a governmental function in its administration of the PERS. CalPERS has an independent and direct relationship with employers who participate in the System and is the primary party responsible for the collection of contribution obligations of an employer to the System. The City's options to transfer its plans to

another plan administrator are limited. Absent special legislation, the City may only transfer its plans to the County Plan and there are reasons to believe this option may not be practically available or desirable to the City.

Termination of a CalPERS plan of the size of the City's has never occurred before. Terminations of any plan are rare, especially in the recent past. However, it is clear that termination by the City would result in the assessment of a termination liability in the range of $1.6 billion and it is likely that CalPERS would be required to reduce benefits upon termination of the Stockton plans if this termination liability were not paid in full. Importantly, benefits can ***only*** be reduced following termination and assessment of termination liability. CalPERS has a lien that secures the termination liability, and this lien is not avoidable under section 545 of the Bankruptcy Code.

The City's objectives and those of the State of California are best served by confirmation of Stockton's Plan without comment on issues that could have damaging effects on the public employment retirement systems of the State of California.

Respectfully submitted,

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