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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re: CITY OF STOCKTON, CALIFORNIA, Debtor.	Case No. 12-32118 D.C. No. OHS-11 Chapter 9 **REPLY OF FRANKLIN HIGH YIELD TAX-FREE INCOME FUND AND FRANKLIN CALIFORNIA HIGH YIELD MUNICIPAL FUND TO THE CALPERS BRIEF REGARDING PENSION LIABILITIES** Date: May 12, 2014 Time: 9:30 a.m. Dept: C, Courtroom 35 Judge: Hon. Christopher M. Klein

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Despite the City's best efforts to fully insulate pensions from any impact or prejudice resulting from this case, CalPERS has inserted itself into these proceedings and filed a twenty-page brief seeking to justify its preferential treatment under the Plan.[1] In light of the Court's recent comments regarding the need to assess the nature and extent of the City's future pension liabilities, Franklin submits this limited response to certain of the arguments made by CalPERS. As shown below, there would be nothing "illegal" about an adjustment of the City's pension liabilities through a plan of adjustment. To the contrary, as demonstrated in Franklin's objections to confirmation, the City cannot achieve confirmation through a cram down of Franklin's claim via a payment of less than 1% without even attempting to restructure those liabilities.

I. THE CITY HAS THE AUTHORITY TO MODIFY PENSION OBLIGATIONS THROUGH A PLAN OF ADJUSTMENT

Franklin has shown elsewhere that the City's future pension liabilities are truly massive. The City projects that its annual payments to CalPERS will more than triple in just a decade – from $14 million in Fiscal Year 2011-12 to $42 million in Fiscal Year 2020-21, and then climb to $54 million a decade later in Fiscal Year 2030-31. By Fiscal Year 2019-20, pension payments will consume 18.5% of the City's general fund, with the safety plan accounting for an astounding 57% of payroll according to CalPERS. To make matters worse, the pension liabilities are unpredictable and completely out of the City's control, as they are dependent on contribution rates established by CalPERS. Those contribution rates have tended to increase year over year, making it difficult if not impossible to prepare responsible and accurate forecasts.[2]

The City's pension liabilities thus pose a clear and present danger to the City's future viability. Despite that undeniable fact, CalPERS asserts that any modification (or even attempted

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[1] Capitalized terms not defined in this Objection have the meanings given to them in Franklin's previously-submitted Summary Objection ("Obj.") and in the Plan. The CalPERS brief [doc. no. 1308] is cited as "CalPERS Br." This Brief is intended to address some of the relevant issues in summary form, and is not a through treatment of those issues. Should the Court so desire, Franklin will supplement the analysis below with a more fulsome analysis.

[2] *See* Obj. at 23-24.

modification) of the City's pension obligations in this case would be "illegal."[3] As shown below, CalPERS is incorrect.

A. The Tenth Amendment Does Not Prohibit Impairment Of Pension Liabilities.

CalPERS seeks refuge in provisions of California state law that, it asserts, make it "an arm of the State of California" and allegedly protect it against impairment in a chapter 9 case as a result of the protections of the Tenth Amendment.[4] CalPERS, however, ignores the fact that, by operation of the Supremacy Clause, state laws purporting to benefit state creditors (including the state itself) in a municipal bankruptcy case are preempted and superseded by the Bankruptcy Code. U.S. CONST. art. VI, § 2 ("This Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land").

The Supreme Court has made clear that "[t]he Federal government possesses supreme power in respect of bankruptcies." *New York v. Irving Trust Co.*, 288 U.S. 329, 333 (1933) (citation omitted). As a result, when in conflict, federal bankruptcy law preempts contrary state law, rendering the state law inapplicable. *See In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal. 2009) [*Vallejo I*] (a chapter 9 debtor may reject collective bargaining agreements under section 365 of the Bankruptcy Code notwithstanding conflicting state labor law), *aff'd*, 432 B.R. 262 (E.D. Cal. 2010) [*Vallejo II*].

This Court already has examined the interplay between state and federal law and concluded that state laws like the ones on which CalPERS now relies are ineffective in a chapter 9 case. Specifically, confronting the argument by the association of retired City employees that state law prohibited the City from reducing retiree health benefits, the Court held that retiree benefits could be impaired in chapter 9 and that the allegedly contrary state law was preempted. *In re City of Stockton*, 478 B.R. 8, 14-16 (Bankr. E.D. Cal. 2012).

This was not a groundbreaking or novel conclusion. In *Vallejo*, for example, Judge McManus held that California law did not impede or in any way modify the City of Vallejo's ability

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[3] CalPERS Br. at 14. Having boldly made that proclamation, however, CalPERS then asserts that "[i]t would be improper for this Court to opine" on the issue. *Id.* at 15.

[4] CalPERS Br. at 1-2, 5.

to reject labor contracts in its chapter 9 case because contrary state law was preempted. *Vallejo I,* 403 B.R. at 75. Similarly, Judge Rhodes recently quoted at length and followed this Court's retiree decision in concluding that the City of Detroit's pension obligations could be impaired in a chapter 9 case notwithstanding allegedly contrary state law. *In re City of Detroit*, 504 B.R. 97, 150 (Bankr. E.D. Mich. 2013).

Contrary to the assertions of CalPERS, neither the Tenth Amendment nor section 903 of the Bankruptcy Code prohibit the City from altering or impairing its pension obligations. The Tenth Amendment provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X. There is no question that, absent state consent, the Tenth Amendment prohibits a municipality from seeking bankruptcy protection or otherwise impairing or discharging its obligations in violation of applicable state law. That is the fundamental holding of *Ashton v. Cameron County Water Improvement District*, 298 U.S. 513 (1936), in which the Supreme Court held unconstitutional the first municipal bankruptcy law because it enabled cities to seek bankruptcy protection even over the objection of the state in which they were located. *Id.* at 531 ("nothing in this tends to support the view that the federal government, acting under the bankruptcy clause, may impose its will and impair state powers – pass laws inconsistent with the idea of sovereignty").

By the same token, there also is no question that, where the state consents, the Tenth Amendment provides no barrier to municipal bankruptcy. That is the fundamental holding of *United States v. Bekins*, 304 U.S. 27 (1938), decided two years after *Ashton*, in which the Supreme Court held chapter 10 of the Bankruptcy Act (the precursor to chapter 9 of the Bankruptcy Code) to be constitutional because it was premised on state consent in the form of authorization for municipalities to seek bankruptcy protection. The Supreme Court explained that, with state consent, the municipal bankruptcy law provided a remedy that the states could not provide on their own due to the prohibitions of the Contracts Clause. *Id.* at 53-54 ("The State acts in aid, and not in derogation, of its sovereign powers.").

State consent is the key. Once a state has authorized a municipality to seek bankruptcy protection, the interests of state sovereignty are at an end with respect to fundamental bankruptcy issues regarding the adjustment of debts. Simply put, the authorization provisions "empower states to act as gatekeepers to their municipalities' access to Chapter 9. In turn, a state's authorization that its municipalities may seek Chapter 9 relief is a declaration of state policy that the benefits of Chapter 9 take precedence over control of its municipalities." *Vallejo II*, 432 B.R. at 267-68 (emphasis added). To hold otherwise would run afoul of the Bankruptcy Clause's provision for uniform bankruptcy laws:

> If chapter 9 permitted states to define all properties of the debtor in bankruptcy regardless of the situation and to rewrite bankruptcy priorities, then chapter 9 would become a balkanized landscape of questionable value. Moreover, chapter 9 would violate the constitutional mandate for uniform bankruptcy laws.

In re County of Orange, 191 B.R. 1005, 1020 (Bankr. C.D. Cal. 1996) (emphasis in original).

This was Judge Rhodes' precise holding in the recent *Detroit* opinion regarding pensions: "Because under the Michigan Constitution, pension rights are contractual rights, they are subject to impairment in a federal bankruptcy proceeding. Moreover, when, as here, the state consents, that impairment does not violate the Tenth Amendment." *Detroit*, 504 B.R. at 154.

B. California Cannot Prohibit Impairment Of Pensions In Chapter 9.

As a consequence, states are not free to pick and choose among the provisions of the Bankruptcy Code that they wish to have applied in any particular municipal bankruptcy case to which they have consented. The case law on this point is clear and unequivocal. As the Court has noted, "[a] state cannot . . . condition or [] qualify, *i.e.* to 'cherry pick,' the application of the Bankruptcy Code provisions that apply in chapter 9 cases after such a case has been filed." *Stockton*, 478 B.R. at 16 (citations omitted). At least two other courts in this District, and one in the Central District of California, have reached the exact same conclusion. *See Vallejo II*, 432 B.R. at 267-68 (same); *Vallejo I*, 403 B.R. at 76; *County of Orange,* 191 B.R. at 1021 ("By authorizing the use of chapter 9 by its municipalities, California must accept chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest.").

This is fatal to CalPERS' assertion that California law – particularly section 20487 of the California Government Code – prohibits rejection of the City contract with CalPERS (the "CalPERS Contract") or impairment of pension liabilities. Section 20487 purports to exempt contracts with CalPERS from the reach of section 365 of the Bankruptcy Code. *See* Cal. Gov't Code § 20487 ("Notwithstanding 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 [the Bankruptcy Code] or any similar provision of law . . . ."). As such, it is exactly the sort of "cherry picking" law that courts have condemned.

In fact, section 20487 is substantively identical to the law found to be preempted in *Mission Independent School District v. Texas*, 116 F.2d 175 (5th Cir. 1940), which involved a state law that attempted to exempt state-owned municipal bonds from discharge in a municipal bankruptcy. *Mission*, 116 F.2d at 176. The Fifth Circuit determined that, once the state had authorized its municipalities to file a bankruptcy case, state law providing for preferential treatment of state-owned debt was invalid:

> The Bankruptcy Act as a law of Congress made in pursuance of the Constitution of the United States, is part of the supreme law. It makes no provision for separate or preferential treatment of a bondholding state as a creditor. The State of Texas bought the bonds it holds for the school fund, and paid for them just as others did. It obtained no better right to repayment. The bonds it holds against its own subdivisions as an investment stand just as though they were municipal bonds issued in another state. The State of Texas is simply a bond creditor as others are.

Id. at 178. Thus, the Fifth Circuit, more than 70 years ago, rejected the exact argument CalPERS would like to resurrect now.

In its decision regarding retiree health care claims, the Court cited the *Mission* case approvingly for the proposition that a state "cannot immunize . . . [itself] . . . from impairment." *Stockton*, 478 B.R. at 17. Similarly, in *Vallejo*, Judge McManus concluded that California labor law allegedly restricting the debtor's ability to reject or impair obligations arising under collective bargaining agreements was preempted: "Assuming for sake of argument that California law

superimposes its labor laws onto section 365, such law would be unconstitutional. Incorporating state substantive law into chapter 9 to amend, modify or negate substantive provisions of chapter 9 would violate Congress' ability to enact uniform bankruptcy laws." *Vallejo I*, 403 B.R. at 76-77 (emphasis added) (citations omitted); *accord Vallejo II*, 432 B.R. at 270 ("incorporating state labor law is, as the Bankruptcy Court so found, prohibited by the Supremacy Clause, the Uniformity [Bankruptcy] Clause and the Contracts Clause").

Notwithstanding this dispositive authority, CalPERS argues that section 20487 of the Government Code remains enforceable because California somehow "conditioned" its authorization for the City's bankruptcy case on observance of those laws.[5] This is wrong in at least two ways. First, the *Mission* case clearly rejected as unconstitutional any state precondition to filing for municipal bankruptcy that contradicts rights granted by the Bankruptcy Code. *Mission*, 116 F.2d at 178. Even had California attempted to do so, section 20487 would represent an unconstitutional attempt to "cherry pick" favored provisions of the Bankruptcy Code.

Second, California's authorization statute – section 53760 of the Government Code – does not incorporate the state law on which CalPERS relies. To the contrary, the recent amendments to section 53760 creating the pre-bankruptcy "neutral evaluation process" removed any plausible argument (to the extent there ever was one) that California has attempted to condition access to chapter 9 on compliance with section 20487. Specifically, the revised version of section 53760 removed the prior version's introductory phrase "Except as otherwise provided by statute," making clear that section 53760 is the sole source of authorization – and limitations on authorization – for commencement of a chapter 9 case in California. *Compare* Cal. Gov't Code § 53760 (2011) ("Except as otherwise provided by statute, a local public entity in this state may file a petition and exercise powers pursuant to applicable federal bankruptcy law.") (emphasis added) *with* Cal. Gov't Code § 53760 (2012) (removing "except as otherwise provided by statute," and replacing it with alternative preconditions for filing: (1) that the municipality "participate[] in a neutral evaluation

[5] CalPERS Br. at 5 n.7.

process pursuant to Section 53760.3" or (2) that it "declare[] a fiscal emergency and adopt[] a resolution by a majority vote of the governing board pursuant to Section 53760.5").[6]

C. Section 903 Of The Bankruptcy Code Does Not Prohibit Impairment Of Pension Obligations.

Section 903 of the Bankruptcy Code also does not provide any substantive limit on the application of the Bankruptcy Code sections incorporated into chapter 9, including provisions authorizing rejection of contracts and discharge of debt. Rather, section 903 merely affirms that chapter 9, by its terms and operation, appropriately reserves the power of the state to control a municipal debtor in the exercise of its political and governmental powers in accordance with the Tenth Amendment. *See County of Orange*, 191 B.R. at 1017, 1021. Section 903 thus offers no solace to a state (or here CalPERS) in its capacity as a creditor. 6 COLLIER ON BANKRUPTCY ¶ 922.02[4] (16th ed. 2013) ("Section 903 is directed toward the relationship of sovereignty between the state and its municipality and should not be construed to extend to any debtor-creditor relationship between them, thereby enabling the state to obtain preference over all other creditors in the conduct of a municipal bankruptcy case.").

Moreover, even if section 903 required deference to state law in respect of obligations to public pension systems (which it does not), CalPERS could not prevent rejection and impairment of its contract and claim because the services of CalPERS as an administrator to the City's pension plans do not reflect "power of a State to control . . . a municipality . . . in the exercise of [its] political or governmental powers." 11 U.S.C. § 903. Although CalPERS argues that the CalPERS Contract is "not of the same character as a commercial contract,"[7] it is clear that the obligations of CalPERS under the contract have nothing to do with the State of California's "control" over its municipalities.

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[6] Moreover, *Vallejo* correctly held that the now-excised phrase "except as otherwise provided by statute" did not incorporate other substantive California law in any event, but merely referred to individual limitations on the bankruptcy of specific types of municipalities: "With respect to the prefatory phrase, 'Except as otherwise provided by statute,' in section 53760, neither it nor any other California law imposes pre-filing limitations or post-filing restrictions requiring compliance with, or making applicable, public sector labor laws." *Vallejo I*, 403 B.R. at 76.

[7] CalPERS Br. at 5.

Rather, by the CalPERS Contract, CalPERS merely administers pension plans covering City employees and retirees, as provided in the City's collective bargaining agreements. As demonstrated by several California cities' use of private entities as their pension administrators (*e.g.*, Fresno, Los Angeles, San Diego, and San Jose), pension administration is not a sovereign activity of the State of California, and CalPERS' activities as a pension administrator do not implicate state sovereignty. Rather, the CalPERS Contract is a commercial contract just like contracts between a city and a private pension administrator.

Indeed, California law does not establish CalPERS as one statewide retirement system protecting all public employees. Rather, state law authorizes a variety of retirement system options for employees of local jurisdictions. For example, counties can establish their own retirement system. *See* Cal. Gov't Code § 31500. Similarly teachers are members of a separate state retirement system, CalSTRS, that has nothing to do with CalPERS. *See* Cal. Educ. Code § 22501. The attempt to characterize the CalPERS Contract as anything other than a standard, commercial contract because CalPERS is an agency, or "arm," of the State therefore must fail.

Moreover, even if the CalPERS Contract enjoyed special "sovereign" status, CalPERS would not be immune from impairment in bankruptcy. To the contrary, the Supreme Court has reiterated that states acting as creditors are subject to federal bankruptcy laws. *See, e.g.*, *Van Huffel v. Harkelrode*, 284 U.S. 225 (1931) (debtor may sell property free and clear of a state tax lien); *Irving Trust,* 288 U.S. 329 (late-filed state tax claim barred); *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440 (2004) (state bound by bankruptcy court's discharge order notwithstanding alleged sovereign immunity). Further, California has waived whatever sovereignty protections CalPERS otherwise might possess by authorizing its municipalities to file for bankruptcy. *Stockton*, 478 B.R. at 22 ("[S]overeign immunity is voluntarily abrogated to the extent provided in § 106.").

Simply put, the unique provisions of chapter 9 are designed to protect sovereign debtors, not sovereign creditors. It is axiomatic that, subject to limited exceptions specified in chapters 3 and 5 of the Bankruptcy Code, the states sit on equal footing with all other creditors in a debtor's bankruptcy case, whether it be a case commenced under chapter 7, 9, 11, 13 or 15.

II. CALPERS' THREATENED PENALTY CLAIM IS NEITHER ALLOWABLE NOR SECURED

CalPERS also threatens the specter of a massive "termination" claim and statutory lien in the event of impairment in the bankruptcy case.[8] CalPERS, however, effectively concedes that a large portion of that claim would not be an allowed claim because it would exceed the City's actual pension liability.[9]

Moreover, whatever the allowed amount, the termination claim would not be secured by the alleged statutory lien arising under section 20574 of the Government Code, which provides for "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." Cal. Gov't Code § 20574. In particular, the automatic stay precludes both termination of the CalPERS Contract and the attachment of any lien during this case. *See, e.g.*, 11 U.S.C. §§ 362(a)(4), 362(a)(5) (prohibiting "any act to create, perfect, or enforce any lien against property of the estate" and "any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title"); *In re CSC Indus., Inc.*, 232 F.3d 505, 510 (6th Cir. 2000) (section 362(a)(4) prevented an ERISA lien from arising after the petition date).

Moreover, even if CalPERS otherwise had a valid statutory lien, the lien would be avoidable under section 545 of the Bankruptcy Code, which provides for avoidance of a lien on property of the debtor if the lien "is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists." 11 U.S.C. § 545(2). Here, the lien under section 20574 would arise only if and when the City rejects the CalPERS Contract and thereby becomes a "terminated agency." Thus, if the City were to terminate the CalPERS Contract during the bankruptcy case, the City could avoid any purported lien. Then, after confirmation of a plan

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[8] CalPERS Br. at 9-11.

[9] CalPERS Br. at 10 ("a terminated agency's actuarial liability upon termination is larger than the actuarial liability on an ongoing basis").

providing for impairment of pension obligations, the City would be protected by the discharge injunction. 11 U.S.C. § 944.

III. CONCLUSION

For all of these reasons, CalPERS is simply incorrect in asserting that the City has no ability to impair its massive pension obligations in this case and that, in the event of such impairment, the City would be crippled by a massive secured claim. As a consequence, the points that Franklin makes in its pending objection to confirmation of the Plan remain valid and unassailable, and Franklin requests that the Court deny confirmation unless and until the City provides Franklin with a fair and equitable recovery rather than the 1% cramdown payment it now proposes.

Dated: April 21, 2014

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