buckconsultants

xerox

FYI®
For Your Information®

Volume 38 | Issue 21 | February 3, 2015

Public Pension Plan Update

Public pension liability remains a hot, fast-moving, and fluid topic. Recent state and local legislation altering public pension rights has attracted a slew of legal challenges, the results of which have varied. Below we discuss several recent, major developments in the public pension sphere. Specifically, we examine legal challenges to pension reform passed by the state of New Hampshire, state of Illinois, and city of Atlanta; how Detroit's art collection enabled the bankrupt city to drastically reduce pension cuts; and the treatment of pension debt in two California municipal bankruptcy proceedings.

In this article: Background | NH Supreme Court and Pension Reform Legislation | Illinois Supreme Court to Hear Pension Reform Case | Atlanta Can Require Increased Employee Contributions | Detroit's "Grand Bargain" | Bankrupt CA Cities to Pay CalPERS in Full | In Closing

Background

In the wake of the 2008 financial crisis, many states and localities have, in various ways, sought to reduce their mounting pension liabilities. As discussed in our April 23, 2014 *For Your Information*, legal protections for public pensions are a matter of state, rather than federal, law, and these protections differ from state to state. Therefore, legal challenges to public pension reform and other efforts at reducing public pension liability have resulted in a patchwork of decisions throughout the country rather than a unified body of law.

New Hampshire Supreme Court and Pension Reform Legislation

In 2007 and 2008, as a way to address underfunding issues, the New Hampshire legislature enacted a law that effectively decreased state employee pension benefits. Specifically, it did the following to future benefit accruals: (1) changed the formula for calculating the "earnable compensation" that determines pension benefits, and (2) eliminated annual cost-of-living adjustments (COLAs). In 2009, some retirement system members, along with their unions, filed a lawsuit arguing that this law violated their vested pension rights under both the state and the federal constitutions.

The case wound its way through the New Hampshire courts for several years, creating financial uncertainty for the retirement system, its members, and its contributing employers. In 2013, the trial court handed down a mixed bag, ruling that, for system members with 10 or more years of creditable service and therefore considered “vested,” the changed definition of “earnable compensation” violated both state and the federal constitutional protections. The trial court determined, however, that system members do not have a vested right to a COLA.

On January 16, 2015, a unanimous New Hampshire Supreme Court rejected the challenges to the legislation. Reversing the trial court’s decision on this issue, the state Supreme Court found no contractual prohibition against a change in law that prospectively modifies the terms of a future benefit. Further, the Court upheld the trial court’s finding that members have no vested right to a COLA.

> **Comment.** This ruling came on the tails of another unanimous New Hampshire Supreme Court decision, issued on December 10, 2014, that rejected a challenge to 2011 legislation increasing member contribution rates. The system members and unions could ask the US Supreme Court to review this decision; however, it is not clear that they will opt do so. Even if they request review, the US Supreme Court may not agree to hear the case — thus leaving the New Hampshire Supreme Court decision intact. Meanwhile, the legislative changes will remain in effect.

Illinois Supreme Court and Pension Reform Case

In late 2013, Illinois passed a pension reform bill designed to address the state’s unfunded pension liability of nearly $100 billion by raising the retirement age, decreasing cost of living adjustments (COLAs), and implementing a cap on salary for purposes of determining pensions, among other changes. For more information on Illinois pension reform, please see our April 23, 2014 *For Your Information.*

In early 2014, a coalition of labor unions challenged the 2013 law, arguing that it violates state constitutional protection for public employee pensions. On November 21, 2014, an Illinois Circuit Court judge agreed with the coalition and struck down the law. Rejecting the state’s position that “reserved” sovereign or police powers allowed it to modify pension obligations in the face of a fiscal crisis, the court held that the Illinois Constitution’s Pension Protection Clause — which provides that membership in a public retirement system is an enforceable contractual relationship, the benefits of which may not be diminished or impaired — contains no such exception.

The state appealed the ruling to the Illinois Supreme Court, which agreed to hear the case on an expedited basis; oral arguments are expected to take place this spring. The union coalition is hoping that a recent Illinois Supreme Court decision reversing the circuit court’s dismissal of claims grounded in the Pension Protection Clause that a law requiring state retirees to start contributing toward their health insurance premiums bodes well for its challenge to pension reform.

> **Comment.** Separately, unions representing Chicago municipal employees have challenged a recent law that increases employee contributions and limits COLAs as part of a plan to remedy Chicago’s poorly funded retirement system.

If the Illinois Supreme Court strikes down the 2013 law as unconstitutional, the Illinois legislature will have to consider other ways to address the state’s pension funding shortfall.

Volume 38 | Issue 21 | February 3, 2015

Lower Court: OK for Atlanta to Increase Employee Contributions

In response to an estimated pension deficit of $1.5 billion, and following more than a year of negotiations with municipal unions and other stakeholders, the Atlanta City Council approved sweeping pension reform effective November 1, 2011. This ordinance increased the amount of annual compensation that employees must contribute toward the city's defined benefit plans from 7 or 8% of pay to 12 or 13%. The city estimated that the legislation, which also placed certain new employees into a combination defined benefit/defined contribution plan and bumped up the retirement age, would save the city approximately $20 million a year and prevent about 200 city workers from being laid off.

In 2013, a group of city employees filed a lawsuit, arguing that the increased contributions violated the Impairment Clause of the Georgia State Constitution and breached the terms of their employment contracts. On November 10, 2014, a Georgia state court judge rejected this challenge. The court found that the state constitution allows the city to modify pension systems, Georgia statutes authorize localities to provide financing methods for those systems, and the Atlanta city charter sets forth procedures for modifying pension laws. Moreover, the court held, because the statutes that established the pension systems expressly provide for their modification, there is no vested contractual right to an unchanged contribution percentage. The court also ruled that the changes were consistent with employment contracts, in which members agreed to participate in the pension systems pursuant to the legislation establishing and governing the systems "as amended, or as may hereafter be amended."

The employees have appealed this ruling, and the case may ultimately be heard by the Georgia Supreme Court. If the decision is upheld, this case could serve as an important — and possibly influential — example of a court refusing to strike down legislation crafted and agreed to by stakeholders representing both employer and employee interests.

Detroit's "Grand Bargain"

As detailed in our April 23, 2014 and December 19, 2013 *For Your Information* publications, the Detroit Bankruptcy Court allowed the City of Detroit to proceed with its plan to restructure under Chapter 9 of the US Bankruptcy Code notwithstanding the Michigan State Constitution's prohibition on the impairment of public employee pension rights. This ruling suggested bleak prospects for Detroit's municipal pensions; in its February 2014 proposed plan of debt adjustment, the city asked for a 34% decrease in pension benefits for most municipal retirees and a 14% decrease for retired firefighters and police officers. Additionally, Detroit's emergency manager considered the Detroit Art Institute's collection as among the municipal assets available to satisfy the city's debt.

A strong desire to save Detroit's art collection, however, ultimately brightened prospects for Detroit's retirees. Under a settlement known as the "Grand Bargain" that the bankruptcy court approved on November 7, 2014, charitable foundations and the State of Michigan agreed to provide the city with $816 million to help fund municipal pensions. In exchange, the city agreed to transfer ownership of its art collection to a nonprofit organization. Thanks to this cash infusion, most retirees will take a cut of just 4.5% to their monthly pension checks along with the elimination of COLAs — changes that, while no doubt unwelcome to pensioners, are far less drastic than earlier forecasts. Police and firefighter retirees will not see any cut to their monthly pension checks, although their 2.25% annual COLA will

drop by 45%. Active employees will be provided benefits under a new hybrid pension plan that is less generous than the now-frozen traditional defined benefit plan.

While the bankruptcy court judge said that the Grand Bargain "borders on the miraculous," some of Detroit's other creditors — including its municipal bondholders — argue that the deal unfairly prioritizes the claims of Detroit's retirees. Additionally, many have criticized the agreed-upon funding formula, which depends on strong, consistent investment returns averaging at least 6.75% per year for the next 10 years. Because pensions are a huge portion of Detroit's liabilities, there is concern that another fiscal crisis could return the city to a financially perilous state — and without the ability to sell off art as a way to satisfy debt.

Detroit emerged from Chapter 9 protection on December 10, 2014. Whether miraculous or inequitable, the Grand Bargain shows that political, social, and cultural factors can influence the treatment of municipal pensions in the Chapter 9 bankruptcy context.

Bankrupt California Cities to Pay CalPERS in Full

In summer 2012, two California cities — Stockton and San Bernardino — sought Chapter 9 bankruptcy protection. These filings put the cities' contributions to CalPERS, the state's pension plan, in jeopardy.

Stockton Honors Pension Liabilities, Slashes Investor Debt

Since the start of its Chapter 9 proceedings, Stockton, a city with a population of approximately 300,000 located about 80 miles east of San Francisco, has stopped bond payments and scaled back certain city services in efforts to reduce its liabilities. However, it has not attempted to alter its obligations to CalPERS — even while trying to reduce significantly the debts it owes to investors.

In an October 1, 2014 hearing, the bankruptcy court judge issued a key ruling that CalPERS, as a municipal bankruptcy creditor, is not entitled to special protection. CalPERS contracts with cities can be cancelled, the court held, just like other agreements that are subject to modification under the US Bankruptcy Code. While a significant legal determination that could serve as precedent in other Chapter 9 cases, this ruling did not ultimately affect Stockton's obligations to CalPERS. On October 30, 2014, the court approved the city's proposed plan, which left the city's CalPERS obligations fully intact. In approving a plan that privileges pension over other forms of debt, the judge said he was persuaded that the plan "is the best that could be done in terms of restructuring the city's debts."

> **Comment.** Unlike most of the city's other creditors, money manager Franklin Resources, Inc. (d.b.a. Franklin Templeton Investments) refused to settle, arguing throughout the Chapter 9 proceeding that pension debt should not receive special treatment. Under the plan as approved by the court, Franklin will collect only about 1% of the unsecured $36 million the city owes it.

Stockton is expected to emerge from Chapter 9 protection in the coming months but continues to face daunting economic challenges.

Mediation with San Bernardino Yields Favorable Results for CalPERS

San Bernardino, a city of about 213,000 located approximately 60 miles east of Los Angeles, immediately stopped making required payments to CalPERS when it sought Chapter 9 protection. The bankruptcy court appeared to

sanction this approach, refusing to allow CalPERS to sue the city to meet its $1.7 million monthly contribution obligation or to have the court dismiss the bankruptcy petition entirely, as CalPERS argued it should.

Meanwhile, in 2013, the court ordered CalPERS and the city to participate in confidential mediation sessions. Through this mediation, the parties reached an agreement announced on November 17, 2014, under which the city will maintain in full its obligations to CalPERS, as well as repay all of the previously withheld CalPERS contributions, with interest.

> **Comment.** This agreement surprised many, coming just weeks after the Stockton court ruled that CalPERS contracts could be modified in the bankruptcy process. While it seems not to have influenced the parties to the San Bernardino mediation, the Stockton court's decision could pave the way for other California cities struggling with their pension obligations to try and trim that debt through the Chapter 9 process.

The proposed plan of debt adjustment, due by May 30, 2015, will explain what liabilities the city proposes to cut now that pensions are off the table.

> **Comment.** In the meantime, a bond holder recently sued the city for giving preferential treatment to CalPERS over other creditors.

In Closing

States and localities looking to reduce pension liabilities will surely continue to face legal challenges. Indeed, courts issue decisions in these cases frequently, and it is necessary to monitor these developments closely and continuously. The potential influence of the developments to date on other public pension systems, however, is unclear. On the one hand, courts could look to other jurisdictions' pension reform efforts and municipal bankruptcy experience for guidance. On the other, context-specific circumstances have proven hugely influential when the fate of state or municipal pensions is at stake.

Volume 38 | Issue 21 | February 3, 2015

Authors
Julia Zuckerman, JD
Joanne Jacobson, JD, LLM

Produced by the Knowledge Resource Center of Buck Consultants at Xerox
The Knowledge Resource Center is responsible for national multi-practice compliance consulting, analysis and publications, government relations, research, surveys, training, and knowledge management. For more information, please contact your account executive or email fyi@xerox.com.

You are welcome to distribute *FYI®* publications in their entireties. To manage your subscriptions, or to sign up to receive our mailings, visit our Subscription Center.

This publication is for information only and does not constitute legal advice; consult with legal, tax and other advisors before applying this information to your specific situation.

©2015 Xerox Corporation and Buck Consultants, LLC. All rights reserved. Xerox® and Xerox and Design® are trademarks of Xerox Corporation in the United States and/or other countries. Buck Consultants®, FYI®, and For Your Information® are trademarks of Buck Consultants, LLC in the United States and/or other countries.