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11 UNITED STATES BANKRUPTCY COURT  
12 EASTERN DISTRICT OF CALIFORNIA  
13 SACRAMENTO DIVISION

14 CITY OF STOCKTON, CALIFORNIA

15 Debtor,

16 Case No: 2012-32118

17 Chapter 9

18 **REPLY MEMORANDUM OF STOCKTON CITY**  
19 **EMPLOYEES ASSOCIATION, ET AL.**  
20 **REGARDING IMPAIRMENT OF PENSIONS**  
21 **AND IN SUPPORT OF STOCKTON'S PLAN**  
22 **OF ADJUSTMENT**

23 Date: October 1, 2014  
24 Time: 10:00 a.m.

25 Hon. Christopher Klein

26 The Stockton City Employees Association, Stockton Professional Firefighters – Local  
27 456 and Operating Engineers Local No. 3 (“Unions”) submit this reply to the Post-Trial Brief  
28 filed by the Franklin Tax-Free High Yield Fund and Franklin High Yield California Municipal  
Fund (“Franklin Brief”).

**I. INTRODUCTION**

Franklin’s Brief contains four assertions to which the Unions find it necessary to reply,  
because they are palpably absurd or seriously flawed as a matter of law.

1 First, contrary to decades of California Supreme Court decisions (which Franklin never  
2 cites), interpreting California law to the contrary, Franklin asserts that “[t]here is no state policy  
3 prohibiting impairment of pension benefits” (Franklin Brief 29). This assertion is false.

4 Second, without ever expressly explaining the legal basis for its contention, Franklin  
5 erroneously implies that the Public Employees’ Pension Reform Act of 2013 (Government  
6 Code §§ 7522, *et. seq.* [“PEPRA”]) provides no benefit to Stockton employees by obtaining  
7 employment with another CalPERS member agency (Franklin Brief 50).

8 Third, Franklin inconsistently argues on the one hand that Stockton employees will have  
9 no incentive or reason to leave their employment with Stockton if their pensions are reduced  
10 by 60%; but then argues on the other hand that Stockton could ameliorate the risk of employee  
11 defection by increasing employee compensation and benefits (Franklin Brief 50).

12 Finally, Franklin denigrates the contributions in the form of reduced compensation,  
13 benefits and changes in work rules that Stockton employees, through their collective  
14 bargaining units, made first in an effort to help Stockton avoid bankruptcy and then in a further  
15 effort to enhance the feasibility of a plan of adjustment (Franklin Brief 45-6). Franklin’s  
16 assertions in this regard are both factually wrong and insensitive to the substantial sacrifices  
17 made by Stockton employees that have adversely affected their lives for several years and will  
18 continue to do so for years to come.

19 **II. ARGUMENT**

20  
21 **A. California has a strong policy against impairment of public employee**  
22 **pensions.**

23 Franklin culls a single provision from California’s extensive Public Employee  
24 Retirement Law “PERL”), a law that is replete with protections for public employees,  
25 misconstrues the culled provision, and ignores decades of California Supreme Court decisions  
26 to assert that California has no policy against impairment of public employee pensions

1 (Franklin Brief 29). The absurdity of Franklin's assertion is demonstrated by its own brief,  
2 where at page 41 it correctly asserts that "[o]utside of bankruptcy the City has no ability to  
3 negotiate, reduce or otherwise impair [its pension] liability." The reason why that is true is  
4 because California law essentially prohibits involuntary impairment of public employee  
5 pensions by functioning public agencies.

6 A long line of California Supreme Court cases, tracing back at least to *Kern v.*  
7 *City of Long Beach*, 29 Cal. 2<sup>nd</sup> 848, 179 P.2d 799 (1947), have held that vested pension rights  
8 of public employees in California cannot be impaired. *E.g.*, *Betts v. Board of Administration*, 21  
9 Cal. 3<sup>rd</sup> 859, 863-4, 582 P.2d 614 (1978); *Allen v. City of Long Beach*, 43 Cal. 2<sup>nd</sup> 128, 287 P.  
10 2<sup>nd</sup> 765 (1955).) As the Court said in *Kern v. City of Long Beach*, 29 Cal. 2<sup>nd</sup> at 856, *supra*  
11 (internal Citations omitted):

12  
13 [O]ne of the primary objectives in providing pensions for government  
14 employees,... is to induce competent persons to enter and remain in public  
15 employment. It is obvious that this purpose would be thwarted if a public employee  
16 could be deprived of pension benefits, and the promise of a pension annuity would  
17 either become ineffective as an inducement to public employees or it would become  
18 merely a snare and a delusion to the unwary.

19 Accordingly, we conclude that petitioner has a vested pension right and that  
20 respondent city, by completely repealing all pension provisions, has attempted to impair  
21 its contractual obligations. This it may not constitutionally do, and therefore the repeal is  
22 ineffective as to petitioner.

23 Franklin contends that "the PERL expressly contemplates that benefits will be reduced  
24 in the event a member agency terminates its contract with CalPERS and is unable to make the  
25 termination payment...." (Franklin Brief 30). The PERL contemplates nothing of the sort. First,  
26 the withdrawal of a member agency from CalPERS does not terminate that agency's pension  
27

1 obligations to its employees.<sup>1</sup> At most it terminates the agency's obligation to make payments  
2 to CalPERS. Second, the PERL gives CalPERS powerful tools to enforce and collect the  
3 termination payment in order that CalPERS may continue to pay the vested pension benefits of  
4 the former member agency. Indeed, Franklin concedes as much in later portions of its brief  
5 that withdrawing from CalPERS is difficult for and painful to member agencies (Franklin Brief  
6 46-7). Third, failure of a former member agency to make its termination payment and  
7 CalPERS (unlikely) inability to collect the payment possibly relieves CalPERS of the obligation  
8 to continue to make full pension payment to employees of the former member agency. The  
9 agency, however, is not relieved of the obligation to pay the promised pension benefits under  
10 the rule of *Kern v. City of Long Beach*, 29 Cal. 2<sup>nd</sup> 848, 179 P.2d 799, supra, and its progeny.  
11

12 A careful analysis of the California Public Employee Pension Law ("PERL") further  
13 demonstrates the fallacy of Franklin's contentions.  
14

15 Franklin states, on page 29 of its brief, that "it cannot be said that state law prohibits the  
16 adjustment or impairment of pension benefits" and that the PERL "expressly contemplates that  
17 benefits will be reduced in the event a member agency terminates its contract with CalPERS."  
18 (Franklin Brief 30 (emphasis original). Franklin has misconstrued both the PERL and related  
19 California law.  
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21 While PERL's contracting agency termination provisions allow for modification of  
22 benefits to reflect the employer's and employees' contributions history, see California  
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25 <sup>1</sup> Franklin did not address the issue raised by the Unions that in addition to withdrawing  
26 from CalPERS Stockton would have to reject all its collective bargaining agreements in order  
27 to impair pensions.

1 Government Code § 20580,<sup>2</sup> the reduction in benefits permitted as a result of a deficiency in a  
2 termination liability is quite small under § 20578(b). The interplay of these sections, and  
3 Franklin’s misapprehension of the PERL are described below, but it should first be noted that  
4 Franklin’s broad point regarding California law and public policy was recently and categorically  
5 rebuffed by the Legislature when it enacted the Public Employee Pension Reform Act  
6 (“PEPRA”). The Legislature’s most recent enactment on this point, § 7522.10(a), confirms that  
7 benefits may not be reduced for existing employees, to wit:  
8

9           The Legislature reserves the right to modify the requirements of this  
10 subdivision with regard to all public employees subject to this section,  
11 except that the Legislature may not modify these provisions in a manner  
12 that would result in a decrease in benefits accrued prior to the effective  
13 date of the modification.

14           Importantly, § 7522.02(a)(1) provides the terms of PEPRA apply “notwithstanding any  
15 other law.” It is therefore inescapable that, in addition to the century of California Supreme  
16 court precedent regarding public pension benefits outlined above and in prior briefs, the  
17 Legislature’s most recent pronouncement is that accrued pension rights may not be reduced.  
18 The idea that Stockton could impair pension by simply withdrawing from CalPERS and  
19 refusing to make its termination payment is a chimera that exist only in Franklin’s imagination.  
20

21           Franklin also draws too broad a point where it states, without citation, that the PERL  
22 expressly contemplates reductions of benefits. With respect to the contracting agencies, the  
23 PERL regulates the relationships between CalPERS and the agency. There is nothing in the  
24 PERL that permits or authorizes an employer to reduce employee benefits or to terminate its  
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26 <sup>2</sup> Unless otherwise indicated, all citations to code sections in Parts A and B are to the  
27 California Government Code.

1 CalPERS contract without providing a commensurate benefit to its vested employees. With  
2 respect to CalPERS, however, the PERL provides narrow parameters to affect accrued  
3 benefits in the event that a contracting agency terminates participation and defaults on its  
4 obligation.

5 Section 20578(b) ensures that a member's benefits earned up to the three year period  
6 prior to notice of a termination of the contract with CalPERS are ensured and cannot be  
7 reduced. Section 20578(b) provides:

8  
9 If a contracting agency has not paid the system for any deficit in funding for  
10 earned benefits, as determined pursuant to Section 20577, members shall be  
11 entitled to the benefits to which members of the plan were entitled 36 months  
12 prior to the date the agency notified the board of its intention to terminate its  
13 contract or 36 months prior to the date the board notified the agency of its intent  
14 to terminate the contract, whichever is earlier. Entitlement to earned benefits  
15 under this subdivision shall be subject to Section 20577.5.

16 Because § 20577.5 permits the Board of Administration the discretion to decline to reduce  
17 benefits when the combined terminated agency pool has sufficient assets to absorb the  
18 terminating agency's unfunded actuarial liability, § 20578 ensures Stockton's employees'  
19 benefits will be maintained at the levels that existed three years prior to the date any notice of  
20 termination is given.

21 Franklin has turned California jurisprudence on its head by suggesting that because  
22 CalPERS *may* slightly reduce benefits in the event Stockton declines to pay its statutory  
23 obligations, that California policy *endorses* the withholding of payment to affect benefits. This  
24 thinking was rejected by the California Supreme court seventy years ago in *England v. City of*  
25 *Long Beach* 27 Cal.2d 343, 348, 163 P.2d 865 (1945) which soundly rejected any "theory that  
26 the provisions of the charter were designed to create an appearance of granting pensions  
27 while at the same time withholding the benefits by providing inadequate funds." Courts have  
28 rejected similar arguments in the ensuing decades, and there is no California authority that  
endorses Franklin's proposition as a matter of policy. E.g. *Bellus v. City of Eureka*, 69 Cal.2d

1 336, 444 P.2d 711 (1968); *England*, 27 Cal.2d at 343, supra.

2 Franklin goes even further afield by suggesting that § 20485 urges instrumentalities of  
3 the state to pursue defined contribution plans (“DC”). Stockton may not adopt a DC plan for  
4 existing employees, who have earned a past, present and future right to receive their benefits  
5 under a defined benefit plan. California law does not allow for alteration to benefits mid-  
6 stream. Perhaps, like in San Diego as outlined in PORAC’s amicus brief, a city can adopt a  
7 defined contribution plan for future employees, but it may not do so for existing employees who  
8 are entitled to a pension upon their retirement. “Upon acceptance of public employment [one]  
9 acquire[s] a vested right to a pension based on the system then in effect” and “on terms  
10 substantially equivalent to those then offered by the employer ....” *United Firefighters v. Los*  
11 *Angeles* 210 Cal.App.3d 1095, 1102, 259 Cal Rptr. 65 (1989) (citations omitted) (citing cases);  
12 *Pasadena Police Officers Assn. v. Pasadena* 147 Cal.App.3d 695, 703, 195 Cal. Rptr. 339  
13 (1983). “This right arises before the happening of the contingency which makes the pension  
14 payable, and it cannot be constitutionally abolished by subsequent changes in the law.”  
15 *Wallace v. City of Fresno*, 42 Cal.2d 180, 183, 265 P.2d 884 (1954) (citation omitted).

16 Under state law, the right of Stockton employees to a defined benefit pension accrued  
17 on acceptance of employment, it has been earned as a component of deferred compensation  
18 through their public service, they have the right to continue to earn such a pension until, finally,  
19 they retire and their right matures. The right is therefore a continuing one that exists  
20 throughout their career and into retirement. This right is not severable to a point in time, such  
21 as a Chapter 9 filing. Franklin’s suggestion that the City may adopt a defined contribution plan  
22 for its current employees does not merely *diminish* their pension rights, it eliminates them  
23 entirely. Even if Franklin’s proposal were a possibility, Stockton employees can easily  
24 preserve their right to receive their defined pension by simply leaving Stockton and working at  
25 any of the many hundreds of public agencies that provide pension reciprocity. As noted below,  
26 PEPRA actually encourages this.

1 While Franklin extolls the virtues of a defined contribution plan, adopting such a plan in  
2 a legally permissible manner would have no effect on Stockton's current pension liabilities  
3 which are necessarily associated with prior service. To reiterate: adopting a defined  
4 contribution plan for new employees will have zero effect on Stockton's current pension  
5 liabilities.

6 In essence, Franklin is seeking more than a diminution of employees' pension benefits,  
7 it seeks their wholesale elimination.

8 **B. PEPRA does provide incentives that would encourage Stockton's**  
9 **employees to seek employment with other public agencies in the event**  
10 **Stockton withdrew from CalPERS.**

11 Even before PEPRA was enacted, the terms of the PERL encourage employees to  
12 abandon Stockton in the event their CalPERS benefits are reduced or frozen, as a result of its  
13 reciprocity provisions. §§ 20351 and 20353. PEPRA in turn creates additional incentives for  
14 employees to leave Stockton so that they can continue to accrue their unmodified and,  
15 importantly, pre-PEPRA "grandfathered" pension benefits. The PERL's provisions regarding  
16 termination liability and the possibility of default virtually require any right-minded employee to  
17 leave for another agency.

18 Although PEPRA instituted statewide pension reform by mandating specified levels of  
19 defined benefits for all new public employees (excepting those enrolled in an independent  
20 charter city plan or the University of California Retirement Plan),<sup>3</sup> PEPRA also provides broad  
21 statutory rights on the part of all employees. For example, PEPRA prohibits requiring  
22 employees to contribute more than fifty percent of the annual normal cost of their pension  
23 benefits and *completely* insulates employees from being required to contribute to a pension  
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25 <sup>3</sup> Pursuant to § 7522.02(a)(1), PEPRA applies to "all state and local participating retirement  
26 systems *and their employers*," and under subsection (b) its terms apply to charter entities who  
27 participate in public retirement systems established under state statute.

1 system's unfunded liabilities. (See § 7522.30). However, PEPRA is particularly protective for  
2 grandfathered employees, meaning those employed prior to its passage on January 1, 2013.

3 By mandating a new pension tier for state and local public employees, PEPRA has  
4 created conditions that will encourage Stockton employees to leave Stockton if their benefits  
5 are diminished. This is because PEPRA ensures that any public employee who was hired  
6 prior to January 1, 2013, is entitled to reciprocity rights in any other state or local system, and  
7 that such employees have the right to enter and maintain their pre-PEPRA benefits with their  
8 new employers. In other words, their grandfathered status under PEPRA is portable. This  
9 affects Stockton because, simply by changing employers, Stockton employees preserve their  
10 preferable pre-PEPRA pension tier, notwithstanding any action by the Court in these  
11 proceedings. This individual statutory right, which is beyond the reach of the bankruptcy court,  
12 is contained in § 7522.02(c), and provides:

13  
14 Individuals who were employed by any public employer before January 1, 2013,  
15 and who became employed by a subsequent public employer for the first time on  
16 or after January 1, 2013, shall be subject to the retirement plan that would have  
17 been available to employees of the subsequent employer who were first  
18 employed by the subsequent employer on or before December 31, 2012, if the  
19 individual was subject to reciprocity established under any of the following  
20 provisions (1) [the PERL]; (2) [the CERL]; and (3) Any agreement between  
21 public retirement systems to provide reciprocity to members of the systems.”

19 This provision is binding both on retirement systems and employers such as the City.

20 §7522.02(a)(1) [“this article shall apply to all state and local public retirement systems and to  
21 their participating employers.”]. Because of the PERL’s reciprocity provisions, Stockton  
22 employees will also be permitted to transfer their service credits to their new employer under  
23 § 20353.

24 The statutory right to earn service under a pre-PEPRA plan, and to transfer service  
25 credits as a result of the reciprocity provisions, is a statutory right of which Stockton employees  
26 can and will avail themselves. Through these statutory entitlements, Stockton employees may

1 preserve their pension benefits notwithstanding the actions of this court. They simply obtain  
2 another job at virtually any other California public agency, and transfer their service credits.

3 There is also a counter-point to this fact, equally pertinent to the City's interest in  
4 preserving competitive pension benefits. After this proceeding Stockton may wish to honor its  
5 statutory obligation to with respect to any employees that have pre-PEPRA grandfathering  
6 rights. To the extent Stockton may wish to recruit California public employees with more than  
7 three year experience, it will have to be able to offer them a commensurate, pre-PEPRA  
8 benefit. To the extent the Court permits pension benefits to be impaired, it is unclear how  
9 Stockton can accommodate these employees' statutory rights and recruit them.

10 PEPRA's and the PERL's pension and reciprocity rights for employees of CalPERS  
11 contracting agencies are significant, as they promote portability of credited pension service  
12 from one contracting agency to another (as well as counties, the state and any other plan with  
13 a reciprocity agreement with CalPERS). If pension benefits were defeated by contract  
14 termination to the maximum extent under § 20578(b), that is, the past 36 months, then any  
15 Stockton employee could also purchase these three years of qualified service credits once  
16 they were employed at another CalPERS agency (or the agency may purchase it for them in  
17 an effort to recruit qualified and experienced personnel). In other words, by simply switching  
18 agencies, a Stockton employee can maintain his current pension levels and buy-back any lost  
19 service credits resulting from this proceeding. Furthermore, Stockton, for its part, will be unable  
20 to recruit experienced candidates to fill these vacancies. In the end, it is Stockton's citizens  
21 who will suffer.

22 **C. The suggestion that Stockton could retain its employees after impairing**  
23 **their pension by increasing compensation and benefits and/or creating a**  
24 **defined contribution plan lacks sufficient analysis to be taken seriously**

25 The suggestion that Stockton could ameliorate the likely employee exodus upon drastic  
26 reductions in pensions by increasing the employee's compensation and benefits is purely

1 speculative as proposed by Franklin. Franklin offers no empirical evidence that employees  
2 would in fact remain employed by Stockton in the face of drastic pension reductions provided  
3 their compensation were increased. Nor does Franklin offer any evidence of what level of  
4 increased compensation and benefits would be necessary to achieve the desired result; or  
5 how that cost would compare to the alleged savings by reducing pensions. In order to be  
6 taken seriously, such an argument would have to be supported by extensive evidence  
7 regarding its validity and a fairly detailed cost-benefit analysis as to whether such an approach  
8 would in fact achieve net savings. Franklin's argument is completely devoid of such evidence  
9 or analysis.

10           Additionally, Franklin's idea that Stockton could substitute a defined contribution  
11 pension plan for its present pension plan misapprehends California public pension law, as  
12 discussed at pages \_\_\_\_, above.

13           **D. The sacrifices made by employees prior to and during the chapter 9**  
14           **process are not insubstantial as suggested by Franklin and have been and**  
15           **will continue to be felt by the employees over a long period of time.**

16           In its Disclosure Statement filed November 15, 2013 (Docket No. 1205), Stockton  
17 succinctly summarized and page 20 the significant reductions in compensation and benefits of  
18 its employees which were negotiated prior to the commencement of this case and which have  
19 continued through the pendency of the case, as follows:

20           The City's recent labor agreements made substantial cuts to  
21 compensation and  
22 benefit packages for current employees, including eliminating their future  
23 retirement health coverage (worth approximately \$26,000 per employee per year),  
24 requiring current employees to pay 100% of the employee share of their CalPERS  
25 contribution (7-9% of salary), and imposing compensation reductions that varied, but  
26 averaged 10% to 33%, of which 7% to 30% was in pensionable income reductions that  
27 would impact future pensions as well as current income.

28           The City believes that the compensation changes made **over the last**  
**three years**, along with the changes in pension benefits for new hires, have eliminated  
the excesses in its compensation/pension system. (Emphasis added.)



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