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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 Chapter 9 DC No. OHS-15 Date: October 1, 2014 Time: 10:00 a.m. Dept. C Courtroom 35

POLICE UNIONS' REPLY TO FRANKLIN'S POST-TRIAL BRIEF[1]

Franklin's 71-page brief focuses primarily on the argument that the City's relationship with CalPERS *can* be terminated, and spends very little time on the question of whether it *should* be terminated. Franklin even goes so far as to insist that neither "good faith" nor "business judgment" is relevant. Yet the evidence shows that, even if the Court ruled that it is possible to "reject" the CalPERS relationship as an executory contract, it still would make no sense to do so

[1] This is the reply of the Stockton Police Officers Association and Stockton Police Managers Association (the "Police Unions") to Franklin's Post-Trial Brief (docket #1689), submitted by Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund ("Franklin").

because there are no feasible alternatives. The uncertainty while a new retirement plan was being devised, as well as the almost certainly less-attractive benefits offered under a new plan, would result in a staffing catastrophe, with devastating effects on public safety and other City services.

Franklin claims that the Plan is not "in the best interests of creditors," but it is very clear that this phrase has only one meaning to Franklin: "not in the best interests of Franklin." The impact on other creditor constituencies of breaching the settlements reached with them, and essentially starting the entire negotiation and mediation process over from scratch, are not even mentioned. Even for Franklin itself, the Plan is almost certainly better than what Franklin would end up with if the case were dismissed.

1. **Whether or not it is possible to "reject" the CalPERS "contract," it makes no sense for the City to do so.**

Franklin spends 42 pages of its 71-page brief[2] arguing that the City's relationship with CalPERS is an "executory contract" subject to rejection under 11 U.S.C. § 365, that even without § 365 the City could terminate the relationship under state law, and that the resulting rejection damages, or termination liability, would not be secured and could, therefore, be impaired via the Chapter 9 bankruptcy process.

These arguments miss the point. The Police Unions have already *assumed*, in their Supplemental Memorandum on the CalPERS issues raised by the Court,[3] that the CalPERS relationship could be rejected under § 365, and that the lien that would secure the termination liability could be avoided under 11 U.S.C. § 545. Even with these assumptions, it would make no sense for the City to go down the path of rejection.

[2] Pages 4-34 and 52-63.

[3] Docket #1659, the "Supp. Memo," page 2.

a. Rejection would be devastating to the Retirees and those close to retirement, many of whom are Stockton residents.

A rejection, combined of course with only a partial payment of the termination liability,[4] would result in reduction of the vested pension benefits of retirees, ex-employees with vested benefits, and current employees (collectively, "members"). This reduction, while it would depend upon current portfolio value and actuarial assumptions made at the time of the termination, and would be a matter decided by the CalPERS Board in its discretion, was estimated by CalPERS deputy chief actuary, David Lamoureux, to be nearly 60%.

For retirees, and for other members with only a few years to go before retirement, a reduction in benefits of this magnitude would be a devastating blow. Many of these individuals depend on their CalPERS pensions as their principal or only means of support in retirement, and a 60% reduction – combined with the elimination of their health care benefits – would render them close to destitute.

b. Rejection would have a devastating impact on Police Department staffing.

Current employees, and police officers in particular, would leave in droves if the City terminated the CalPERS relationship. Police Chief Eric Jones testified that Stockton's Police Department is already "not competitive in the marketplace with other police departments, [which] is drastically affecting our retention and recruitment." The Police Department has been unable despite several years of effort to reach budgeted staffing levels, because its hiring barely keeps up with attrition.[5] Termination of the CalPERS contract would take a serious human resources problem and turn it into a catastrophe.

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[4] Not having to pay the termination liability would, of course, be the only reason to bother terminating. Because of more conservative actuarial assumptions and the fact that it is payable immediately, payment of the termination liability is far more onerous than maintaining the CalPERS relationship intact.

[5] See Supp. Memo, pages 10-11, for citations to Chief Jones' four declarations, portions of which are summarized here.

Attempting to rebut Chief Jones' testimony, Franklin argues that "economically-rational employees considering their situation at the date of impairment would do what all other economically-rational actors would do: they would consider what future job opportunity offers the best compensation package going forward."[6] This argument has several significant flaws.

- First, Franklin assumes that "the City would have enormous flexibility to develop at- or above-market compensation packages for employees if it were not shackled with prepetition liabilities for unfunded pensions,"[7] yet this is nothing but pure speculation. No expert witness for either side testified to any specific, existing alternative for providing retirement benefits. The City's expert Kim Nicholl, however, testified that it would be essentially impossible for Stockton to join the County's system (because all CalPERS liabilities would have to be assumed in order to do so) and that no third-party provider exists that offers turnkey retirement plans to municipalities such as are available to corporate employers. The only remaining option – a newly-created, self-administered system – would, she testified, be difficult, expensive, and time-consuming to set up.[8]
- Second, Franklin ignores the period of uncertainty, estimated by expert witness, Kim Nicholl, as taking at least six months and more likely a year, during which it would not be at all clear what the City's new compensation package was going to be. Many employees would have left long before the situation eventually became clear. Even if the City were, after months of organizational work, able to set up a new plan that was "just as good as CalPERS" (for current employees – the former employees and retirees would, of course, be left out in the cold), the Stockton

[6] Franklin's Post-Trial Brief, page 50.

[7] *Id.*

[8] See Supp. Memo, pages 4-6, for citations to Ms. Nicholl's testimony, summarized here.

Police Department and other city departments would be devastated in the meantime, and it would take years to rebuild them.

- Third, Franklin dismisses the portability and reciprocity features of CalPERS, which would not be available to a self-administered system. To save any money by setting up a new retirement plan, the City would have to cut off the pensions of retirees and former-employees. Yet this would make it impossible to get reciprocity with CalPERS. Both Chief Jones and expert Kim Nicholl testified that reciprocity is very important to police officers and other City employees.
- Fourth, Franklin claims that "economically rational" employees look only at the "compensation package going forward," ignoring the issue of trust. If employees feel their employer has betrayed their trust, they might very rationally leave even if the City could manage to set up a new pension system that was arguably just as good as CalPERS, in favor of an employer they can trust.

c. Rejection would set the reorganization back by months or years.

Rejection of the CalPERS "contract" would breach the collective bargaining agreements reached with the Police Unions and the City's other nine unions, and its settlement with the Official Committee of Retirees, and would require the City to go back to the bargaining table with all of those constituencies, prolonging the bankruptcy case by many months or even years.

Rejection would also add a huge new liability to CalPERS, estimated at $1.6 billion. Even assuming the claim would be unsecured, it would still be huge compared to any of the other claims in the case. A revised Plan that offered only 1% to CalPERS would require a payment to CalPERS of $16 million. Why would Franklin be entitled to a higher percentage on its unsecured claim than CalPERS? CalPERS could also be counted on to litigate, to the maximum extent and at great expense to all, the City's power to reject the contract, and the avoidability of CalPERS' lien, wasting City resources and adding to the issues that would need to be resolved before the City could exit bankruptcy.

2. Confirmation of the Plan is in the best interests of creditors.

Franklin argues that the Plan does not meet the requirement of 11 U.S.C. § 943(b)(7) that "the plan is in the best interests of creditors." But Franklin looks at this requirement from the extremely narrow viewpoint of itself alone; no other creditor constituencies are considered.

Basically, Franklin argues that the City's budget going forward is too conservative, reserving too much money for emergencies and optional items, rather than paying Franklin's unsecured claim in full. But this is not what "best interests of creditors" means.

In Chapter 9, because (unlike in Chapter 11) liquidation is not an option, the "best interests of creditors" test is usually interpreted as a question of whether creditors will be better off under the plan than if the bankruptcy were dismissed. By this measure, the Plan is clearly in the best interests of creditors as a whole, and the fact that essentially all creditors except Franklin have agreed to settlements that are incorporated in the Plan shows that they agree.

But even for Franklin, it is highly unlikely that the dismissal would be better than the Plan. Franklin will receive the full amount of its secured claim under the Plan, plus a partial payment on its unsecured claim. If the case were dismissed, Franklin would be competing with a number of other well-heeled capital markets creditors for payment; those creditors' settlements with the City would go out the window on dismissal, and they would all be litigating and taking enforcement actions simultaneously in a race to tie up the City's limited resources. Similarly, the Retirees would be suing the City for their $545 million in canceled health care benefits, and the Police Unions (and other unions) would be suing for breaches of their collective bargaining agreements. The City government would be defending litigation on all sides while employees, residents, and even businesses would flee, further reducing the tax base and the City's ability to pay. The facts and evidence do not support Franklin's implied assumption that it would receive significantly more than 1% on the unsecured portion of its claim in such a free-for-all.

Franklin also insists that the Plan cannot be in the best interests of creditors because the CalPERS contract will not be terminated or rejected. But even Franklin admits that if the City

were to terminate its CalPERS contract *outside* bankruptcy, CalPERS' rights would dwarf – and trump – those of all other creditors.[9] So Franklin is arguing that termination of the CalPERS contract *in bankruptcy* is required. Franklin does not state what section of the Bankruptcy Code requires this, but it is clearly not § 943(b)(7).

What Franklin wants is the best of both worlds. It wants the benefit of all the settlements the City has reached with every other creditor constituency over the past three years, both before and after this bankruptcy case was filed, and then wants to be paid in full because, all those other settlements having been made, enough money is supposedly left over in the City's budget to pay Franklin in full. This is not the "best interests of creditors" test; it is nothing but complete self-centeredness on Franklin's part.

Franklin also argues that it will receive far less than other unsecured creditors will receive under the Plan. It should be noted, however, that Franklin's repeated mantra that it would receive "less than 1%" of its claim under the Plan is inconsistent with its claim that the Retirees (among other creditor groups) are receiving a higher percentage. If the Retirees' health claims and pension claims are to be blended together to create a supposed recovery of "52% or more,"[10] then Franklin's own secured and unsecured claims should be blended as well. By this measure, Franklin would receive at least a 12% recovery under the Plan. But the Bankruptcy Code looks at classes of claims, not at classes of creditors. Franklin's unsecured claim is receiving exactly the same percentage as the Retirees' unsecured claims for health care benefits, and all other members of Class 12.

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[9] "[T]his bankruptcy case provides the City with its only opportunity to address the problem of its massive unfunded liability for prepetition pension promises. *Outside of bankruptcy, the City has no ability to negotiate, reduce, or otherwise impair that liability.*" Franklin's Post-Trial Brief, page 41 (emphasis added).

[10] Franklin's Post-Trial Brief, page 39. See also page 46 of that brief: "[W]hile the retirees do face a permanent reduction in their health care benefits, they are to receive unimpaired pensions for life as the *quid pro quo* for that reduction. The retirees therefore stand to recover more than 50% of the prepetition claims against the City. Franklin, in contrast, has no *quid pro quo*. It gets 1% and nothing more. Ever."

3. Even if Franklin's unsecured claim were classified separately, and it did not consent, the Plan could still be confirmed as a "cramdown."

Franklin argues that "the City gerrymandered Class 12 specifically to avoid the unfair discrimination test."[11] The test referred to is found in 11 U.S.C. § 1129(b)(1), which provides that a plan can be confirmed, even if an impaired class voted against the plan, "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." Here, of course, Franklin's class *did* accept the plan, so § 1129(b)(1) does not apply.

Moreover, neither § 1122 nor § 1123 requires that all similar claims be classified together; they merely require that dissimilar claims be classified separately. Franklin cites § 1123(a)(4), but that section merely states that a plan shall "provide the same treatment for each claim or interest of a particular class." The City's Plan fulfills this requirement, because each claim in Class 12 receives the same treatment. The fact that many, or perhaps most, creditors holding Class 12 claims also have claims in another class is not relevant. Franklin itself has a claim in another class – its secured claim, which will be paid in full.

So Franklin's argument boils down to this: Franklin should have had *a class of its own*, separate from other general unsecured creditors, so that it could have rejected the Plan, bringing § 1129(b) into play. There is no case law support for this proposition.

But even if the City had, indeed, put Franklin into a class of its own, the Plan could and should still be confirmed. The supposed "discrimination" consists of several secured creditors, who are arguably only partially secured (no hearing on valuation of their collateral having been held), being paid a percentage considerably higher than 1% on their *combined secured and unsecured claims*. Franklin has not shown that these creditors are being paid dramatically more on the unsecured portions of their claims than Class 12, and the City has shown ample business justification for classifying each of these creditor groups separately because of the mixed nature of their claims and the importance to the City of retaining the collateral.

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[11] Franklin's Post-Trial Brief, page 39.

As for the "discrimination" of paying Retiree pension claims in full while Class 12 claims receive a much lower percentage, the fact of the matter is that the City has made the decision not to alter – or, if you will, to assume – its contract with CalPERS. Having done that, the City has no choice but to pay the pension claims in full. For all the reasons discussed above, termination or rejection of the CalPERS contract would be a disastrous decision. Thus, there is ample business justification for classifying the pension claims separately from Class 12.

Section 1129(b)(1) also requires that a plan be "fair and equitable" to an impaired, non-consenting class. Because of Franklin's insistence on a valuation of its collateral, Franklin's claim has been bifurcated into a secured and an unsecured claim. Section 1129(b)(1) does not apply to the secured claim, because it is not impaired; that claim will be paid in full on the Effective Date. As for Franklin's unsecured claim, §1129(b)(2)(B) defines "fair and equitable," and requires only that no holder of a claim junior to the non-accepting class receive anything under the plan. This Plan fulfills that requirement. No class of creditors that is junior to Franklin's *unsecured* claim will receive anything. The Plan is therefore "fair and equitable" to Franklin.

CONCLUSION

Notwithstanding its lengthy briefs, Franklin fails to supply any valid reasons why the Plan should not be confirmed. Rejection of the CalPERS relationship, even assuming that it is possible, would blow apart the entire structure of settlements upon which the Plan is based, create a huge new liability to CalPERS and cause major litigation with CalPERS, render many Retirees destitute, breach the City's collective bargaining agreements and alienate its workforce, devastating the City.

Franklin argues that the requirement that a Chapter 9 plan be "in the best interests of creditors" essentially means that one holdout creditor must receive plan treatment at least as good as the best treatment offered to any other creditor under the plan. Franklin chose never to settle, while everyone else did. Now Franklin wants the best treatment of all under the Plan. This is not what "best interests of creditors" requires. It only requires that the plan be better for creditors than dismissal. Under this test, the Plan is in the best interests of all creditors, including Franklin.

Finally, Franklin's argument that it is being unfairly discriminated against is specious. Other creditors who are being paid more have collateral securing at least part of their claims, or are holders of pension claim, which must be paid if the CalPERS relationship is maintained – which it must be.

Respectfully submitted,

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