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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-15 Chapter 9

FRANKLIN'S POST-TRIAL BRIEF

Continued Confirmation Hearing

Date: October 1, 2014
Time: 10:00 a.m.
Dept: C, Courtroom 35
Judge: Hon. Christopher M. Klein

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Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund (collectively, "Franklin") submit this post-trial brief pursuant to the Court's request at the hearing held on July 8, 2014, and in response to submissions made by supporters of the City's Plan.[1]

I. PRELIMINARY STATEMENT

In their voluminous new submissions, the City and its organized labor allies conspicuously avoid the basic question – can the Court confirm a plan that provides full payment of the City's massive prepetition liability for unfunded pensions, delivers recoveries ranging from 52% to 100% for all other material unsecured creditors, yet crams down a sub-1% payment on Franklin?

The answer is no. The City and its employees – who naturally want to preserve their favorable treatment under the plan – thus try to change the subject. They argue instead that there are good "business justifications" for the City's (preordained) decision to leave pensions untouched. There are two fundamental problems with that argument.

First, the testimony and evidence at trial revealed those "justifications" to be pretext, cloaking the City's true goal of shedding debt for borrowed money while shielding employees from the burden of this restructuring. The City's decision to forgo the only opportunity available to adjust its largest unsecured liability – brought about by years of "pension spiking" and unfunded promises of lavish benefits – is simply irresponsible.

Second, and more importantly, the plan supporters fail to address – much less resolve – the plan's fatal defect. Whether or not the City's reasons for preserving pensions are valid, the Bankruptcy Code affords no preferential or exalted position to a municipal debtor's unfunded

[1] This brief responds to submissions of the City ("City Br."), CalPERS ("CalPERS Plan Br." and "CalPERS Pension Br."), the Retirees Committee ("Retiree Br."), the Stockton Police Officers' Association ("SPOA Br."), the Stockton City Employees Association and allied unions ("Union Br."), *amicus* Peace Officers Research Association of California ("PORAC Br."), and *amicus* International Association of Fire Fighters ("IAAF Br."). By responding to the *amicus* briefs, Franklin does not concede that the *amici* or their submissions are properly before the Court, and Franklin reserves the right to object to the filing of those briefs at the appropriate time. Undefined terms have the meanings given to them in Franklin's prior objections to Plan. Copies of relevant trial exhibits, transcript excerpts, legislative histories, state authorities, and other materials are compiled in the accompanying Compendium and are cited as "Comp. ___" with reference to the Compendium's consecutive pagination.

pension liabilities, no matter how much the municipality would like to honor those liabilities. The rules of the game remain the same, whether the debtor's promises are for future employee benefits or to repay borrowed money.

Those rules include the Code's mandate of fair, equitable and nondiscriminatory creditor treatment and baseline recoveries that are in the best interests of all creditors – even those with whom the debtor has failed to reach agreement. They prohibit a debtor from picking and choosing among its creditors, paying some in full and then pleading poverty as a justification for paying others virtually nothing.

The evidence developed over five days of trial negates the City's core thesis that it cannot afford to pay Franklin more than 1% now or ever. A fair, equitable and nondiscriminatory plan would provide for payment of Franklin over time as the City recovers financially – just as the City proposes to treat the other "capital markets" creditors and, indeed, its employees and retirees, who are to receive the benefit of assumed collective bargaining agreements and ongoing, unimpaired pensions over the next half century or longer. The City's shape-shifting "living" Long-Range Financial Plan does the opposite to Franklin. It is designed to suck up every single extra dollar generated by the City for hypothetical "mission critical" expenses the City has not even identified. With a forecast ending cash balance in excess of $114 million on top of $236 million of extra "mission critical" spending over the next three decades, the City's assertion that it cannot spare additional funds for Franklin defies belief (and reality).

The City's recent actions confirm this. At trial, the City proclaimed that it could not possibly pay Franklin any more than $350,000 (1%) on Franklin's claim, which the City asserted to be a wholly-unsecured debt. Then, after the Court valued Franklin's collateral at $4,052,000, the City amended the Plan to provide for payment of that sum in full in cash on the effective date. In other words, since trial the City miraculously found $4 million – in just the first year of its forecast – to pay Franklin's secured claim. Surely the City has the ability to wring more than $305,000 (0.93578% on Franklin's remaining unsecured claim) out of the amorphous Long-Range Financial Plan over the next thirty years. The City's duty as a chapter 9 debtor is to do just that.

The City has now wasted millions of dollars attempting to cram down an unconfirmable plan. Along the way, it has trotted out one baseless and discredited argument after another. It asserted that Franklin's claim arose from a lease that could be rejected and capped at a fraction of the amount loaned to the City, only to concede defeat before trial. After agreeing that Franklin's claim was secured, the City insisted that the collateral was valueless – not worth a single penny. The Court rejected that position to the tune of more than $4 million. This prompted the City to threaten vacuously to return the collateral – forcing Franklin to "eat dirt" – only later to "find" cash necessary to pay the secured claim in full.

This conduct should lead the Court to view the City's core pronouncements with a jaundiced eye. Why should the City be trusted now when it says that it has no money to pay Franklin, given the ample flexibility of the "conservative" Long-Range Financial Plan, the $4 million it just "found," and the continuing improvement in the City's financial fortunes? Why should the City be believed when it says that CalPERS pensions are so sacrosanct that a "mass exodus" of employees would result if it merely suggested a modification of benefits, when it did not even bother to explore available alternatives and entered this case with a preordained mission, put into place by its former City Manager, to protect pensions at all costs by restructuring on the backs of "Wall Street"?

The City and its allies attempt to place the black hat on Franklin. The City claims that Franklin demands that the City "play chicken with its workforce."[2] The retirees argue that denial of confirmation would "send the message that one hold-out creditor can torpedo the extensive mediation efforts of all other creditor groups."[3] The unions argue that a failure to confirm "would undermine all that good faith effort and have much the same effect on the parties as Lucy's pulling the football out from under Charlie Brown."[4] The police claim that "all that effort would be thrown away" if Franklin's objection is sustained and the City is forced to abide by the Bankruptcy Code's requirements.[5] This is empty rhetoric. The only game of chicken is being played by the City, which

[2] City Br. at 1.

[3] Retiree Br. at 2.

[4] Union Br. at 13.

[5] SPOA Br. at 14.

persists in trying to cram down a sub-1% recovery on Franklin while paying all other creditors (pensioners and non-pensioners alike) vastly more.

The time has come for the City to abandon that foolish game, end its crusade, acknowledge its obligations under the Bankruptcy Code, and propose a realistic and reasonable plan of adjustment. Franklin asks the Court to deny confirmation and set the City on an appropriate path toward the exit in this case. To assist the Court in doing so, Franklin addresses the briefs filed by the plan supporters in the pages below.

Franklin first addresses the City's ability to impair pension liabilities in this chapter 9 case, refuting CalPERS' windy but discredited argument that the Constitution insulates pensions and ties the Court's hands, as well as CalPERS' desperate effort to have the Court avoid even considering the question (Section II). Franklin then responds to the City's assertion (echoed by labor) that unfunded prepetition pensions are so important that they cannot be impaired notwithstanding the City's clear ability to adjust them in this case (Section III). As shown below, there is no "business justification" exception to the Bankruptcy Code's confirmation standards and, in any event, there is no true justification for assuming that liability while seeking to cram down a 1% recovery on Franklin. Finally, Franklin shows that CalPERS' hypothetical (and vastly inflated) claim for termination liability is unsecured and does not justify the City's wholesale assumption of pension liabilities (Section IV). That claim for termination liability – in whatever amount and by whomever held – can and must be adjusted equitably with the City's other unsecured liabilities.

II. THE CITY'S PREPETITION PENSION LIABILITIES ARE SUBJECT TO IMPAIRMENT AND ADJUSTMENT IN THIS CASE

According to CalPERS, as of June 30, 2012 – two days after the petition date – the City's unfunded liability for vested pension obligations was $1,618,321,517.[6] In its Plan, the City proposes

[6] Comp. 288 [Trial Ex. 2727 (Safety Plan Valuation Report) ("Safety Plan Rep.") at 28 (calculation of "unfunded termination liability" for Safety Plan)]; Comp. 291 [Trial Ex. 2728 (Miscellaneous Plan Valuation Report) ("Misc. Plan Rep.") at 28 (calculation of "unfunded termination liability" for Miscellaneous Plan)].

to assume that entire liability and thereby shoulder the burden of its prepetition pension promises for the next fifty or more years (however long the pension beneficiaries live).[7] At the same time, the City proposes to pay Franklin less than $305,000 (0.93578%) on its $32,551,625 unsecured claim for money the City borrowed in 2009.[8]

The Court cannot confirm that Plan without resolving the issue of whether or not the City's prepetition pension liabilities are subject to adjustment in this chapter 9 case. As shown below, those liabilities are capable of being impaired in accordance with the standards of the Bankruptcy Code. CalPERS' arguments to the contrary are unfounded and ill-considered.

A. The City's Ability To Impair Pension Liabilities Presents A Live Controversy That The Court Must Resolve As A Condition To Confirmation Of The Proposed Plan.

To start, the City is plainly wrong in deeming the issue of pension impairment "a purely academic question,"[9] as is CalPERS is declaring it an "unnecessary" and "hypothetical question . . . of little significance."[10] This is revealed by the fourteen pages of briefing in which CalPERS urges the Court not to even consider the question.[11] CalPERS doth protest too much. The question is critically important.

The Court will recall that CalPERS made this same argument at trial. Counsel for CalPERS urged the Court to sweep the pension issue under the rug, arguing that it was not "necessary" for the Court to consider it.[12] The Court forcefully disagreed:

> THE COURT: Well, I don't agree with that. When I decide, among other things, whether to confirm the plan, I need to think about what are the alternatives. Otherwise, I'd just mindlessly be rubber-stamping a plan. You might as well hire a potted palm to preside in the courtroom.[13]

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7 *First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California, As Modified (August 8, 2014)* [D.I. 1645] (the "Plan") § IV.P.2.

8 Plan § IV.M.2.

9 City Br. at 2.

10 CalPERS Plan Br. at 1, 42.

11 CalPERS Plan Br. at 1-2, 31-44; CalPERS Pension Br. at 1.

12 Comp. 61-63 [5/13/14 Tr. at 176:7-178:5].

13 Comp. 63 [5/13/14 Tr. at 178:6-10].

The Court concluded that the issue of pension impairment was "a festering sore" that required the Court "to get in there and excise it and figure out what the story is."[14]

CalPERS thoroughly briefed and lost the point.[15] Yet, it now ignores the prior holding and re-argues the "advisory opinion" issue, lecturing the Court about its responsibility to decide only actual cases and controversies. CalPERS' arguments have no more merit now than they did previously. Because the Court already ruled against CalPERS on the question of justiciability, Franklin will respond only in summary form here. Should the Court desire a more fulsome rejection of the rewarmed CalPERS assertions, Franklin will be happy to supplement its analysis.

To start, CalPERS argues that neither the Court nor Franklin "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."[16] In particular, CalPERS asserts that "Franklin cannot demonstrate any injury in fact for Article III purposes."[17] This is beyond ridiculous.

Franklin clearly is "injured" by the City's effort to cram down a sub-1% recovery on it. "[I]n the Chapter 11 context, Article III standing exists where 'the participant holds a financial stake in the outcome of the proceeding such that the participant has an appropriate incentive to participate in an adversarial form to protect his or her interests.'" *In re Thorpe Insulation Co.*, 677 F.3d 869, 887 (9th Cir. 2012) (quoting 7 COLLIER ON BANKRUPTCY ¶ 1109.04 (16th ed. 2014)). In confirmation proceedings, standing to object is afforded to any entity whose "contractual rights," "financial interests," or "litigation rights" might be affected by the proposed plan. *Id.* There is no reason to think that any different standard applies in a chapter 9 case.

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[14] Comp. 60 [5/13/14 Tr. at 174:7-8].

[15] *See CalPERS' Response To Franklin's Objection To Confirmation Of The City Of Stockton's First Amended Plan Of Adjustment* [D.I. 1308] ("CalPERS Resp. I") at 15 ("It would be improper for this Court to opine on any issue that is not actually before it because Federal Courts lack the power under Article III to issue advisory opinions."); *CalPERS' Response To Franklin's Reply Regarding Confirmation Of The City Of Stockton's First Amended Plan Of Adjustment* [D.I. 1434] at 4-5 ("[T]he Court should exercise judicial restraint and avoid deciding these questions because they raise issues of the highest constitutional magnitude which go to the very structure of Our Federalism (*i.e.*, the relationship between the Federal Government and the Sovereign States).").

[16] CalPERS Plan Br. at 32.

[17] CalPERS Plan Br. at 35.

In fact, the Bankruptcy Code affords Franklin the right to "raise and [] appear and be heard on any issue in a case" under chapter 9. 11 U.S.C. § 1109(b) (incorporated into chapter 9 by 11 U.S.C. § 901(a)). This includes the right to "object to confirmation of a plan." 11 U.S.C. § 1128 (also incorporated). Congress intended "to confer broad standing so that those whose rights would be affected by reorganization proceedings could participate and protect their rights." *Thorpe*, 677 F.3d at 888; *id.* at 884 ("On bankruptcy standing, the interests in a fair plan are paramount, and the bankruptcy court is open to all 'parties in interest.'") (quoting 11 U.S.C. § 1109(b)).

In this case, Franklin has objected to confirmation on grounds that include the Plan's failure to satisfy explicit provisions of the Code, including section 943(b)(7) (best interests of creditors), section 1122(a) (classification of claims), section 1123(a)(4) (same treatment of classified claims), section 1129(a)(3) (good faith) and section 1129(b)(1) (fair and equitable treatment and prohibition on unfair discrimination). In each instance, Franklin has argued that the City's failure to adjust its prepetition pension liabilities causes the Plan to violate the statutory prerequisites to confirmation.

The City's refusal to confront its pension problem does not neuter Franklin's ability to raise pension issues in its objection to confirmation, as CalPERS asserts.[18] To the contrary, the City's conduct gives rise to those objections. It matters not whether the City believes that it cannot impair pension liability or whether the City simply chooses not to act even though empowered to do so. The City is deliberately vague on the point. What matters is Franklin's objection that, without impairment of pensions, the Plan cannot be confirmed. A necessary predicate to that objection is a determination of whether the City in fact has the power to impair its prepetition debt to CalPERS. That is the question now before the Court.

One component of that question is the enforceability – or lack thereof – of various provisions of the Public Employee Retirement Law (the "PERL") in which CalPERS seeks refuge, including section 20487 (prohibition on rejection in bankruptcy) and section 20574 (lien upon termination) of

[18] CalPERS Plan Br. at 35 ("Any claimed injury caused by application of California laws, section 903 or the Tenth Amendment, [sic] 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.") (emphasis in original).

the California Government Code. CalPERS' assertion that "those statues are not at issue in this case" – and that the question is not "ripe" for decision – because CalPERS has not "invoked either statute" ignores history and defies reality.[19] CalPERS has "invoked" those statutes in multiple briefs to date,[20] not to mention numerous hearings, and CalPERS devotes dozens of pages to them its two post-trial briefs.[21]

In any event, as noted at trial, the Court has an independent duty to assure itself that the Plan satisfies the Bankruptcy Code's confirmation standards, regardless of Franklin's alleged lack of standing or CalPERS' alleged failure to invoke the preempted statutes. That is the specific holding of *United Student Air Funds, Inc. v. Espinosa*, 559 U.S. 260, 277-78 and nn.14-15 (2010) ("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 the Code) (the Code "requires bankruptcy courts to address and correct a defect in a debtor's proposed plan even if no creditor raises the issue") (emphasis in original). CalPERS cites nothing to support its assertion that section 903 of the Code somehow removes chapter 9 proceedings from the reach of *Espinosa*.[22] To the contrary, the Court correctly noted that, due to the other limitations on day-to-day judicial oversight in a municipal restructuring, "the duty of the Court to be independently persuaded of all essential elements of confirmation actually is somewhat amplified in Chapter 9."[23] CalPERS also cites nothing to support its incredible assertion that the Court lacks the power to explain its forthcoming ruling on confirmation.[24]

CalPERS admits that one possible outcome is a conclusion that "[t]he CalPERS relationship can be impaired and the City's Plan fails to meet the confirmation standards set forth in the Code

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[19] CalPERS Plan Br. at 35, 37.

[20] *See, e.g.*, *CalPERS' Brief In Support Of The City Of Stockton's Petition* [D.I. 711] ("CalPERS Elig.") at 9 (section 20487) and 15 n.12 (section 20574); *CalPERS' Summary Limited Objections And Reservation Of Rights Regarding The City Of Stockton's First Amended Plan Of Adjustment* [D.I. 1255] ("CalPERS Conf.") at 3 (section 20487); CalPERS Resp. I at 5 and n.7 (section 20487) and 11 and n.14 (section 20574).

[21] CalPERS Plan Br. at 25-28 and 30-31; CalPERS Pension Br. at 21-42.

[22] CalPERS Plan Br. at 41.

[23] Comp. 57 [5/13/14 Tr. at 169:22-24 (emphasis added)].

[24] CalPERS Plan Br. at 42 n.30 ("The power to confirm a plan does not provide the Court with the concomitant power to propose, or even suggest, an alternative plan.").

because the City failed to take that into account."[25] To reach that conclusion and sustain Franklin's objection – or to reach the opposite conclusion and overrule Franklin's objection – the Court necessarily has to decide the issues raised by Franklin, including (a) whether the City's unfunded prepetition pension liabilities are susceptible to adjustment in this case, and (b) whether provisions of the PERL that purport to prohibit impairment and elevate CalPERS to a preferred position are enforceable. It matters not that "the City has never taken the position that it cannot legally impair pensions."[26] What matters is that the City has put before the Court a Plan that leaves pensions untouched and seeks to cram down a recovery of less than 1% on Franklin.

These are not questions raised "in a vacuum" and their answer will not result in an "advisory opinion."[27] In order to determine confirmability of the Plan, it is "absolutely necessary" – to use CalPERS' term – to consider and decide whether the City's pension liability may be adjusted. Without a ruling on that core issue the Court could not determine (a) whether the Plan is in the best interests of creditors (it is not, because it proposes to pay massive prepetition pension liabilities that otherwise could be impaired); (b) whether the Plan does not discriminate unfairly and otherwise is fair and equitable (it is not, because it proposes full payment of prepetition pensions while cramming down a vastly-smaller recovery on Franklin); or (c) whether the Plan was proposed in good faith (it was not, because it punitively seeks to wipe out Franklin's claim while leaving untouched the much larger debt for impairable prepetition pension obligations).

The Court can surmise why CalPERS desperately wants it to refrain from issuing a decision on these critical issues. Having injected itself into this case from the very beginning, CalPERS' efforts to avoid the consequences of a decision are hypocritical, to say the least. Whatever its motivations, CalPERS cannot wish away Franklin's standing to raise legitimate objections premised on the City's failure to impair pension liabilities or the Court's independent obligation to determine whether the Plan meets the Code's confirmation standards.

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[25] CalPERS Plan Br. at 41.

[26] CalPERS Plan Br. at 42.

[27] CalPERS Plan Br. at 38-40.

B. The City's Relationship With CalPERS Is Voluntary And Subject To Termination At No Financial Risk To CalPERS.

As observed on July 8, in order to determine whether the City has the ability to adjust unfunded pension liabilities the Court first must ascertain the nature of those liabilities and the parties who would be impacted by their impairment and discharge. Recognizing this, CalPERS seeks to portray itself as the defender of immutable and fundamental interests of the State, effectively asserting that California's entire pension system would be jeopardized by the City's adjustment of its prepetition pension obligations. CalPERS is wrong.

Notwithstanding CalPERS' lofty rhetoric, there simply is no fundamental State interest in need of protection in these proceedings (which likely is why the State itself has chosen not to participate). The City's relationship with CalPERS is a voluntary contractual arrangement for the administration of a pension plan. Applicable state law – the PERL – expressly contemplates that the City may terminate that relationship and cause the impairment of pension benefits if it is unable to satisfy vested liabilities upon termination. Far from being offensive to interests of the State, impairment and discharge in this case are fundamentally consistent with the State's legislative framework governing public employee pensions.

1. The PERL Authorizes The City To Terminate Its Relationship With CalPERS.

To start, nothing in State law requires the City to provide a CalPERS pension or otherwise have any relationship with CalPERS. Rather, a public agency like the City "may participate in and make all or part of its employees members of [the] system by contract entered into between its governing body and the [CalPERS] board." CAL. GOV'T CODE § 20460 (emphasis added) [Comp. 357]; *see also id.* § 20482 ("the contracting agency may elect to continue the local system and to place under this system only a portion of the members of the local system") [Comp. 359]. The Court correctly observed that "[t]he City participates in CalPERS . . . by virtue of contract and the City does not have to do that."[28]

[28] Comp. 151 [7/8/14 Tr. at 29:2-4]. This is different than the way that it works for employees of the State itself. Benefits for State employees are specified in the PERL, Comp. 108-10 [5/14/14 Tr. at 165:12-167:1 (Lamoureux)], and there is no CalPERS contract with the State. CalPERS Plan Br. at 4-5.

Once the voluntary contract with CalPERS is made, public agencies like the City are free to terminate their agreements with CalPERS. *Id.* § 20570(a) ("the governing body [of the contracting agency] may terminate [the contract] by the adoption of a resolution giving notice of intention to terminate") [Comp. 365]; *see also id.* § 20571 (similar provisions for termination through a majority vote of the electorate) [Comp. 367].[29] Similarly, CalPERS can terminate the contract upon a contracting agency's failure to make timely payments or otherwise perform its contractual obligations. *Id.* § 20572 [Comp. 369].[30]

Correspondingly, there are alternatives to a "CalPERS pension" for municipal employers. Mr. Lamoureux testified that municipalities like the City can join a county-run system, contract with a private plan administrator, establish their own plan, or choose not to provide a pension benefit at all.[31] In fact, ***the PERL specifically encourages employers to pursue defined-contribution alternatives to CalPERS pensions***: "It is the intent of the Legislature that contracting agencies in conjunction with recognized local employee organizations, develop alternative retirement plans that provide benefits under a defined contribution program." *Id.* § 20485 [Comp. 361].

The viability of those alternatives is addressed in Section III.B.4, below. The point here is simply that alternatives do exist and, in fact, are encouraged by the State Legislature. The assertion that the State has a special sovereign interest in ensuring that the City refrain from terminating its CalPERS contract is false.

2. CalPERS Assumes No Financial Risk Upon Termination.

Relatedly, neither CalPERS nor the State would be at financial risk if the City chose to terminate its CalPERS contract and adjust its prepetition pension liabilities in this case. To the

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[29] Per Mr. Lamoureux: "The PERL allows for voluntary termination by a contracting agency." Comp. 346-47 [Direct Testimony Declaration Of David Lamoureux [Trial Ex. 4015] ("Lamoureux DTD") ¶ 38]; "[T]here are really two ways that an arrangement with CalPERS could be terminated. The first one would be voluntary termination on the part of the employer." Comp. 111 [5/14/14 Tr. at 176:18-20 (Lamoureux)].

[30] Here again, these are rights that do not exist with respect to State employees. As CalPERS notes, "a municipal employer's participation in the System can be terminated, whereas a State employer's cannot." CalPERS Plan Br. at 5 n.4.

[31] Comp. 116-17 [5/14/14 Tr. at 190:23-191:16 (Lamoureux)]; *see* City Br. at 7-13.

contrary, the PERL specifies that, in the event a terminating agency fails to make the required payment to CalPERS upon termination, ***it is the pension beneficiaries whose benefits are reduced***: "If the agency fails to pay to the board the amount of the [termination payment], all benefits under the contract, payable after the board declares the agency in default therefor, shall be reduced . . . . The right of an employee of a contracting agency, or his or her beneficiary, to a benefit under this system, whether before or after retirement or death, is subject to the reduction." *Id.* § 20577 (emphasis added) [Comp. 375].[32] Put simply, as the Court noted, "CalPERS does not bear the financial risk of a shortfall in payments."[33]

While true that, "[i]n the event of termination, CalPERS assumes the actuarial risk of the terminated agency's member benefits,"[34] that "risk" is solely within CalPERS' control. As explained in Section IV.B, below, CalPERS protects itself against the hypothetical "risk" through extreme "conservatism" in the calculation of an agency's termination liability. In just the past several years, CalPERS changed its calculation methodology to account for "the current economic environment" and "minimize the risk" of any liability whatsoever upon termination.[35] As CalPERS states: "If a terminated agency fails to pay in full the Termination Payment, CalPERS must take steps necessary to ensure the actuarial soundness of the [Terminated Agency Pool]. 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."[36]

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[32] Comp. 349 [Lamoureux DTD ¶ 45 ("because Stockton could not fund its shortfall following a hypothetical termination, in the event that Stockton did not fund a material amount of its contribution obligations, CalPERS would be required to reduce benefits before merging Stockton's assets into the Terminated Agency Pool")]; Comp. 114-15 and 124-27 [5/14/14 Tr. at 180:9-181:3 and 204:24-207:1 (Lamoureux)]; *see* City Br. at 7-13.

[33] Comp. 153 [7/8/14 Tr. at 40:7-8]; Comp. 17 [3/27/13 Tr. at 438:16-18 ("if CalPERS were to be impaired, . . . it is the employees who would suffer, not CalPERS")].

[34] CalPERS Plan Br. at 22.

[35] Comp. 351-52 [Lamoureux DTD, Ex. 11 at 1 and 2].

[36] CalPERS Plan Br. at 23 (emphasis added).

The lack of any material financial risk to CalPERS further illustrates the lack of any material State interest in the question of the City's ability to impair its unfunded prepetition pension liability. Indeed, the Court was right to question whether CalPERS has any interest at all in these proceedings[37] (other than its obvious political interest in portraying itself as a staunch defender of "the integrity of the System and its consistent delivery of promised benefits to CalPERS retirees").[38]

C. The City May Terminate Its Relationship With CalPERS In This Case.

Despite unambiguous provisions of the PERL that entitle the City to terminate its relationship with CalPERS and cause a reduction in pension benefits to its vested beneficiaries, CalPERS argues that the City's contract cannot be rejected in bankruptcy because it is not an executory contract and, even if it were, section 20487 of the California Government Code would prohibit rejection.[39]

This is a curious argument. As shown in Section III.C.2, below, section 20487 clearly is preempted by and ineffective in chapter 9, as it purports to immunize CalPERS from "cherry picked" provisions of the Bankruptcy Code. More importantly, section 20487 is inconsequential. ***Section 20487 says nothing about a municipality's ability to impair its obligations to CalPERS***. It speaks solely to the operation of section 365 of the Code and nothing else. Whether or not rejection under section 365 is available, the City remains free to terminate its relationship with CalPERS and liquidate its prepetition pension obligations in accordance with the PERL. By its terms, section 20487 does not prohibit adjustment of those liquidated prepetition liabilities in bankruptcy.

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[37] Comp. 152-53 [7/8/14 Tr. at 39:19-40:2 ("So the standard solution appears to be that CalPERS, to the extent it does not have accumulated contributions, reduces pensions by that amount. That leads to the interesting question of, well, what is CalPERS then in relation to a case like this? Who is the real creditor? It seems to me that, if you're going to take an individual's pension or part of an individual's pension, the individual employee is the creditor and CalPERS is, in effect, kind of a servicing agency.")].

[38] CalPERS Plan Br. at 3.

[39] CalPERS Plan Br. at 29-31; CalPERS Pension Br. at 21-42.

1. The City May Terminate Its Relationship With CalPERS Whether Or Not The CalPERS Contract Is Executory.

CalPERS argues that its agreement with the City "is not really a contract at all, but is instead primarily a statutory relationship."[40] CalPERS cites no authority for that proposition, which seems plainly wrong given that the City voluntarily opted into the relationship pursuant to a document entitled "Contract" executed by the City and CalPERS, and it thereafter modified the relationship pursuant to a series of "Amendments to Contract" also executed by the City and CalPERS.[41] BLACK'S LAW DICTIONARY (9th ed. 2009) ("Contract" is "1. An agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law. . . . 2. The writing that sets forth such an agreement. . . . 3. A promise or set of promises by a party to a transaction, enforceable or otherwise recognizable at law; the writing expressing that promise or set of promises."). The PERL even labels members of the CalPERS system as "contracting agencies."

In any event, whether "contractual" or "statutory," no one disputes that the City has massive prepetition debt for liabilities arising as a result of its relationship with CalPERS. Just like contractual obligations, monetary statutory obligations are subject to impairment and fully dischargeable in bankruptcy unless specifically exempted (which the City's debts are not). *See* 11 U.S.C. § 944(b) (plan of adjustment discharges debtor "from all debts"); 11 U.S.C. § 524(a) (incorporated into chapter 9 by 11 U.S.C. § 901(a)). This is the precise holding of *Ohio v. Kovacs*, 469 U.S. 274 (1985), in which the Supreme Court held that a debtor's monetary obligation under a state statute was a debt dischargeable in bankruptcy. *Id.* at 279 (rejecting argument by state "that the injunction it has secured is not a claim against Kovacs for bankruptcy purposes because . . . Kovacs' default was a breach of the statute, not a breach of an ordinary commercial contract").

CalPERS also argues that, "[e]ven 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 . . . [because] [s]tate law prohibits the nondebtor party, CalPERS, from failing to perform."[42]

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[40] CalPERS Plan Br. at 29.

[41] Lamoureux DTD, Ex. 8.

[42] CalPERS Plan Br. at 29-30.

This too seems plainly wrong, given the provisions of the PERL that enable CalPERS to reduce benefit payments in the event a terminating agency fails to make its termination payment. More importantly, the "executoriness" of the CalPERS contract is irrelevant. If the contract is not executory, the City's prepetition pension debt remains.

CalPERS cites *In re Texscan Corp.*, 976 F.2d 1269 (9th Cir. 1992), where a contract "was not executory because an Arizona state statute prohibited the insurer 'from stopping performance.'"[43] But CalPERS fails to mention that the result in *Texscan* was discharge of the debtor's remaining obligations under the non-executory contract. *Texscan*, 976 F.2d at 1271 (at issue was "a $80,212 premium deficit"). In this case, the Court already has held that obligations arising under a non-executory agreement are debts subject to adjustment through a plan, concluding that the appropriate action for the City's retirees was "to present claims, have them evaluated, to accept or reject the plan, and to object to confirmation." *In re City of Stockton*, 478 B.R. 8, 25 (Bankr. E.D. Cal. 2012) [*Stockton II*]; *id.* at 27 ("The plaintiffs' asserted right to require the City to continue to pay for health benefits based on their prebankruptcy contractual rights are 'claims.'").

Thus, a declaration that the City's CalPERS contract is not executory does not advance the ball for CalPERS – the City's obligations under that contract remain prepetition obligations that are subject to adjustment and discharge under chapter 9. *See, e.g.*, *In re International Fibercom, Inc.*, 503 F.3d 933, 939-42 (9th Cir. 2007) (prepetition claims arising under non-executory contract are dischargeable); *In re Wicklund*, BAP No. WW-07-1209-JuKMo, 2008 Bankr. LEXIS 4744, at *10-*20 (9th Cir. BAP Jan. 17, 2008) (same).

2. Section 20487 Of The California Government Code Does Not Prohibit Termination Of The CalPERS Relationship Pursuant To The PERL.

CalPERS cites section 20487 of the California Government Code for the proposition that "[a]ny attempt by the City to reject its relationship with CalPERS through the City's bankruptcy would . . . violate State law."[44] This misreads the statute.

[43] CalPERS Plan Br. at 30.

[44] CalPERS Plan Br. at 30.

Section 20487 seeks to remove, by fiat, CalPERS member contracts from operation of section 365 of the Bankruptcy Code, prohibiting both rejection and assumption of those agreements:

> 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 (commencing with Section 901) of Title 11 of the United States Code shall reject any contract or agreement between that agency and the board pursuant to Section 365 of Title 11 of the United States Code or any similar provision of law; nor shall the agency, without the prior written consent of the board, assume or assign any contract or agreement between that agency and the board pursuant to Section 365 of Title 11 of the United States Code or any similar provision of law.

CAL. GOV'T CODE § 20487 (emphasis added) [Comp. 363]. Notably, however, ***the statute says nothing about a contracting agency's ability to terminate its contract pursuant to the PERL via section 20570 of the Government Code***.

Thus, even if section 20487 were enforceable (as shown below, it is not), the City remains free to terminate its CalPERS contract and liquidate its liability for unfunded prepetition pension obligations – the exact same thing that would happen upon rejection of the contract pursuant to section 365 of the Code. Section 20487 simply is not relevant to the question of whether the City is capable of impairing and adjusting its prepetition pension liabilities in this case.

Moreover, section 20487 seeks to address a problem that does not exist. Section 20487 was enacted in the aftermath of Orange County's chapter 9 case. Legislative history states that "CalPERS sponsored this measure to prevent a public agency such as Orange County, [sic] from shifting liability for funding its employees' retirement benefit payments to CalPERS."[45] As the Court observed on July 8, this makes no sense.[46] Under the PERL a contracting agency is free to terminate its contract with CalPERS (section 20570 of the Government Code) and CalPERS is entitled to reduce benefits to the agency's members and avoid liability if the agency is unable to pay

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[45] Comp. 388 [excerpts from legislative history of section 20487]. The State Senate's "bill analysis" confirms this legislative intent: "The Senate Public Employment and Retirement Committee analysis indicates that the recent Orange County fiscal crisis has raised the possibility that a PERS' contracting agency could file a Chapter 9 Bankruptcy, and that the agency's trustee in bankruptcy might seek to reject its contract with PERS, thereby transferring the liability for its retirees' retirement allowances to PERS." Comp. 389.

[46] Comp. 154 [7/8/14 Tr. at 46:16-17 ("who was pulling the wool over the eyes of the California Assembly and State Senate?")]. Answer: "CalPERS sponsored this measure."

the resulting termination claim (section 20577 of the Government Code). There is no risk that a debtor agency could "transfer liability for its retirees' retirement allowances to PERS."

Despite this misguided statutory purpose, section 20487 and its legislative history do reveal some important truths. For one thing, the California Legislature obviously believed that contracts of member agencies with CalPERS are executory contracts. Otherwise, what would be the point of the statute? For another, the Legislature drew a clear line of demarcation between the fiscal interests of the State and the fiscal interests of CalPERS. This is shown by the fact that, notwithstanding the intent to prevent member agencies from "shifting liability for funding [] employees' retirement benefit payments to CalPERS," the legislative analyst opined that "[t]his measure will not result in additional state costs or savings."[47] In other words, prevention of alleged (albeit imaginary) losses to CalPERS would not result in any "savings" to the State itself.

3. The Bankruptcy Code Preempts Section 20487.

Should the Court disagree with this interpretation and conclude that section 20487 does limit the City's ability to impair its pension liabilities, it will be necessary to consider whether the statute is actually enforceable in this case. On July 8, the Court indicated that it "would need a pretty good explanation what authority the California legislature has to revise or condition the application of the Unites States Bankruptcy Code" through section 20487.[48] Neither CalPERS nor its organized labor allies has provided such an explanation.

A good place to start is with the legislative history of section 20487. In it, the California Legislature acknowledged that the statute was of questionable validity, noting that "[a] bankruptcy judge might refuse to recognize the power of the state to control bankruptcy proceedings or to set conditions for using bankruptcy protection."[49] Indeed. As addressed in greater detail below, the Court already has concluded that the State has no power "to condition or to qualify, *i.e.*, to 'cherry

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[47] Comp. 388 [excerpts from legislative history of section 20487].

[48] Comp. 154; 155 [7/8/14 Tr. at 46:19-22; *id.* at 47:5-6 ("I look at this and I just am in wonderment. Does anybody think this is valid and why?")].

[49] Comp. 392 [excerpts from legislative history of section 20487].

pick,' the application of the Bankruptcy Code provisions that apply in chapter 9 cases after such a case has been filed." *Stockton II*, 478 B.R. at 16.

Despite that law of the case, CalPERS seeks to defend section 20487 in two ways. First, it argues that the statute "is part of the State's 'consent' to file for chapter 9 protection"[50] and, second, it argues that "section 20487 is protected by section 903 of the Code and [therefore] is not preempted."[51] CalPERS is wrong on both accounts.

a. *Section 20487 Is Not Part Of The State's Statutory Consent.*

Section 109(c)(2) of the Bankruptcy Code provides that a municipality may not be a debtor under chapter 9 unless it "is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law." 11 U.S.C. § 109(c)(2). In other words, "[t]he state is the chapter 9 gatekeeper by virtue of § 109(c)(2)." *In re City of Stockton*, 475 B.R. 720, 727 (Bankr. E.D. Cal. 2012) [*Stockton I*]. Here, the Court has concluded, as have all other courts to consider the question before it,[52] that section 53760 of the California Government Code provides such authorization: "California has engineered the parameters of its gate in California Government Code § 53760, which authorizes any county, city, district, public authority, public agency, or entity that qualifies as a municipality under the Federal Bankruptcy Code, other than a school district, to be a debtor under chapter 9 but recently imposed preconditions for which this case functions as the maiden voyage." *Stockton I*, 475 B.R. at 727 (footnote omitted).

Section 53760 serves as the sole source of authority for California municipalities to seek protection under chapter 9. Contrary to CalPERS' assertions, section 20487 has nothing to do with the State's authorization or the gatekeeping function performed by section 53760. To start, the text of section 20487 says nothing about authorization to file a chapter 9 case. Rather, the text purports

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[50] CalPERS Pension Br. at 22-29.

[51] CalPERS Pension Br. at 30-35.

[52] *See, e.g.*, *In re City of Vallejo*, 432 B.R. 262, 268 (E.D. Cal. 2010) [*Vallejo II*] ("California Government Code § 53760 authorizes municipalities to petition for bankruptcy."); *In re City of San Bernardino*, 499 B.R. 776, 786 (Bankr. C.D. Cal. 2013); *In re City of Vallejo*, 403 B.R. 72, 76 (Bankr. E.D. Cal. 2009) [*Vallejo I*] (same); *In re County of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996) (same).

to limit the actions of a "contracting agency or public agency that becomes the subject of a case under the bankruptcy provisions of Chapter 9." CAL. GOV'T CODE § 20487 (emphasis added) [Comp. 363]. Section 20487 thus assumes that the agencies to which the statute is directed already are debtors in a bankruptcy case, having been provided authorization to file by section 53760. There is no "interplay between section 20487 and section 53760" as CalPERS asserts.[53]

Further, contrary to CalPERS' mystifying claim that section 20487 was enacted "long before the municipal bankruptcy authorization law,"[54] section 53760 was enacted in 1949 (and itself superseded predecessor provisions enacted as early as 1897),[55] "long before" the State's enactment of section 20487 in 1996 in reaction to the Orange County case. Section 53760 then was amended in 2002 and again in 2011 – after section 20487 was on the books – without any mention of section 20487. Nothing in the legislative history of section 53760 or its amendments even hints at purported eligibility restrictions in section 20487.

To the contrary, the legislative history repeatedly stresses that "California grants its cities, counties, and special districts the broadest possible access to federal bankruptcy."[56] *See Vallejo II*, 432 B.R. at 268. The legislative history of the 2002 amendments states that, "[i]n keeping with historical practice, [the statute] provides local governments with the broadest possible access to federal bankruptcy protections" and explicitly rejects suggestions of State control over a municipality's entry into the chapter 9 process: "the Legislature is effectively choosing in favor of the current system that provides access without state oversight."[57] Similarly, the legislative history of the 2011 amendments notes that "[t]he California State Legislature has a long history, dating back to the Orange County bankruptcy filing in 1994, of debating access to federal municipal bankruptcy

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[53] CalPERS Pension Br. at 26.

[54] CalPERS Pension Br. at 25.

[55] Comp. 407 [excerpt of legislative history section 53760, noting that "[f]ormer Gov C § 53760, relating to consent by State to adoption and application of Bankruptcy Act, was added Stats 1949 ch 81 § 1, and repealed Stats 2002 ch 94 § 3"].

[56] Comp. 410, 411, 413, 415 [excerpt of legislative history of 2002 amendments to section 53760].

[57] Comp. 414 [excerpt of legislative history of 2002 amendments to section 53760].

laws every few years . . . and ultimately in 2002, made the decision to seek the broadest authority for municipal bankruptcies that exists under federal law."[58]

Section 53760's failure to reference, much less incorporate or adopt, the purported restrictions of section 20487 demonstrates that the two statutes are addressed to different legislative concerns: authorization to enter chapter 9 (section 53760) on one hand, and actions to be taken once in chapter 9 (section 20487) on the other hand. To the extent there was a question previously, the 2011 amendments to section 53760 removed any plausible argument that the State attempted to condition access to chapter 9 on compliance with section 20487. Those amendments provide for a neutral evaluation to take place between a distressed municipality and "interested parties." CAL. GOV'T CODE § 53760.3. The term "interested party" is defined to include "a pension fund [and] a representative selected by an association of retired employees of the public entity who receive income from the public entity." *Id.* § 53760.1(e) [Comp. 383]. If CalPERS were correct that section 20487 prohibits California municipalities from impairing or impacting prepetition pension liabilities in a chapter 9 case, there would have been no point in making CalPERS ("a pension fund") an interested party entitled to participate in the pre-bankruptcy negotiations.

Moreover, the amended version of section 53760 removed the prior version's introductory phrase "Except as otherwise provided by statute," making clear once and for all that section 53760 is the sole source of authorization – and limitations on authorization – for commencement of a chapter 9 case. *Compare* CAL. GOV'T CODE § 53760 (repealed 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) [Comp. 377] *with* CAL. GOV'T CODE § 53760 (2012) (removing "except as otherwise provided by statute" and replacing it with alternative preconditions for filing) [Comp. 380].[59]

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[58] Comp. 429 [excerpt of legislative history of 2011 amendments to section 53760].

[59] In any event, the now-excised phrase merely referred to individual limitations on the bankruptcy of specific types of municipalities. *Vallejo I*, 403 B.R. at 76 ("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. The 2002 Comments to section 53760

The bottom line is that section 20487 provides no restriction or condition on the State's authorization for its municipalities to commence bankruptcy proceedings.[60]

b. *Section 20487 Is Preempted Whether Or Not Part Of The State's Statutory Consent.*

Further, whether or not section 20487 is part of the State's consent to the City's chapter 9 case, it is plainly unenforceable.

As noted at trial, the Court already decided this issue.[61] In *Stockton II* (the retiree health care decision), after painstakingly reviewing the applicable constitutional components of municipal bankruptcy, the Court concluded that State law prohibiting the City from terminating vested retirement benefits was preempted by and not enforceable in chapter 9. In the process, the Court rejected the precise argument now made by CalPERS – that the "reservation of state power to control municipalities" in section 903 of the Bankruptcy Code entitles States to pick and choose among provisions of the Bankruptcy Code:

> This reservation is limited by the Supremacy Clause. A state cannot rely on the § 903 reservation of state power to condition or to 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 II, 478 B.R. at 16. The Court held that, simply put, "[w]hile a state may control prerequisites for consenting to permit one of its municipalities (which is an arm of the state cloaked

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identify various California statutes that do impose such limitations, and state labor law is not among them.") (emphasis added).

[60] CalPERS states that "the legislative history of section 20487 specifically references California's former authorization statute on several occasions" and asserts that this is "probative evidence" of legislative intent to make section 20487 "part and parcel" of the authorization statute. CalPERS Pension Br. at 29. The opposite is true. This legislative history proves that the Legislature was well aware of what was (and was not) required for a municipality to commence a chapter 9 case and chose not to modify those requirements in the course of enacting section 20487.

[61] Comp. 58-59 [5/13/14 Tr. at 172:22-173:7 ("Keeping in mind, if you go back and read the retired employees case, that there's a published decision in it that laid out the constitutional aspects that the bankruptcy clause of the constitution trumps the California statutes to the contrary. I should say the combination of the bankruptcy clause in the constitution and the supremacy clause of the constitution trump California law to the contrary, be that California common-law, California statutory law, or the California Constitution. Those are all issues that were raised and resolved in the retiree employees case.") (emphasis added)].

in the state's sovereignty) to file a chapter 9 case, it cannot revise chapter 9." *Id.* at 17. This conclusion went hand-in-hand with the Court's earlier conclusion in *Stockton I* that, although "[t]he state is the chapter 9 gatekeeper by virtue of § 109(c)(2)[,] . . . that gatekeeping function ends once the gate is opened and a chapter 9 case is filed." *Stockton I*, 475 B.R. at 727.

As an explicit attempt to exempt certain contracts from the purview of section 365, section 20487 unquestionably is an effort by the State "to condition or to 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." One could not think of a more blatant example of "cherry picking." Under the reasoning of *Stockton I* and *Stockton II*, section 20487 is invalid and unenforceable.

Stockton I and *Stockton II* are law of the case. *See, e.g.*, *In re White Crane Trading Co.*, 170 B.R. 694, 701 (Bankr. E.D. Cal. 1994) ("when a court decides upon a rule of law, that decision should continue to govern the same issues in subsequent stages in the same case") (quoting *Arizona v. California*, 460 U.S. 605, 618 (1983)). Yet, astonishingly, ***CalPERS never mentions those holdings, much less attempts to distinguish them, in eighty-seven pages of briefs***. This disregard of the Court's thoughtful and thorough treatment of these important issues demonstrates a lack of respect and an inability to distinguish the prior analysis in any meaningful way.

Indeed, CalPERS would have the Court ignore not only its own opinions (*Stockton I* and *Stockton II*) but also all of the ample precedent supporting those opinions.

- <u>*Mission*</u>. For example, in *Stockton II* the Court cited the Fifth Circuit's seminal decision in *Mission Independent School District v. Texas*, 116 F.2d 175 (5th Cir. 1940), for the proposition that a state "cannot immunize . . . [itself] . . . from impairment." *Stockton II*, 478 B.R. at 17. *Mission* involved a Texas statute that authorized municipalities to seek bankruptcy relief but purported to exempt bonds held by units of the State of Texas. *Mission,* 116 F.2d at 177 ("this Act shall not apply to any bond or bonds while held by the permanent school fund of Texas"). The Circuit concluded that the statute would operate "to protect the school owned bonds, while authorizing a composition proceeding otherwise" and thus would "conflict with the provision of the Bankruptcy Act which forbids discrimination among creditors of the same class." *Id.* at 177-78.

Accordingly, the Circuit held that the statute was preempted and unenforceable: "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 [Texas law] fails of effect, either because in conflict with the provisions of the bankruptcy act or because inserted contrary to the State Constitution." *Id.* at 178.

CalPERS deems this to be "enigmatic dictum" that is "just plain wrong under modern day jurisprudence."[62] Each of CalPERS' criticisms, however, are unfounded. CalPERS first says that *Mission* is distinguishable because "the municipal bankruptcy law in effect at that time did not contain any requirement that a municipality actually have any State authorization," citing *United States v. Bekins*, 304 U.S. 27 (1938).[63] This misreads *Bekins*. The entire premise of *Bekins*, in which the Supreme Court upheld the municipal bankruptcy law it had struck down several years earlier, was that the state in question (California) had enacted a statute providing consent for its municipalities to file for bankruptcy. *Bekins*, 304 U.S. 47-48 (citing the predecessor to section 53760 and holding that "the State has given its consent"). The precise question the Court answered in *Bekins* (in the negative) was "whether the exercise of the federal bankruptcy power in dealing with a composition of the debts of the [municipality], upon its voluntary application and with the State's consent, must be deemed to be an unconstitutional interference with the essential independence of the State as preserved by the Constitution." *Id.* at 49 (emphasis added).

CalPERS next says that *Mission* is distinguishable because the Fifth Circuit "did not construe the [Texas] law as a bankruptcy authorization statute; rather, it interpreted the law as excluding [the state bonds] from the operation of any composition made."[64] This is both wrong and irrelevant. First, the Texas law plainly was an authorization statute. As the Circuit noted, "the Legislature has spoken, both by way of consent [to filing] and prohibition [of impairment of State debt]." *Mission*, 116 F.2d at 177 (emphasis added). The Circuit held that the statute provided authorization to file but

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[62] CalPERS Pension Br. at 36.

[63] CalPERS Pension Br. at 36 (emphasis in original).

[64] CalPERS Pension Br. at 36 (emphasis in original) (quotation omitted).

attempted to limit the operation of certain provisions of the Bankruptcy Act. *Id.* at 177-78. This is precisely how CalPERS (incorrectly) says that section 20487 operates. Second, whether or not an authorization statute, the key point is that the Texas law was invalid because it attempted to cherry pick the application of the Bankruptcy Code. This is impermissible, whether the cherry picking occurs in an authorization statute or otherwise. *Stockton I*, 475 B.R. at 727 ("that gatekeeping function ends once the gate is opened and a chapter 9 case is filed").

Undaunted, CalPERS next argues that *Mission* is distinguishable because Texas had purchased its bonds as an investment whereas, "[i]n sharp contrast," CalPERS allegedly is acting to preserve funds "used to pay out pension benefits."[65] CalPERS, however, fails to answer the obvious question: so what? For bankruptcy purposes, the interests of the State of Texas in preserving its "investment" in one of its municipalities are no different than the interests of CalPERS (or, indeed, the State of California itself) in preserving funds used to pay pensions. Nothing in *Mission* turns on whatever superficial distinction CalPERS might seek to draw between the facts of the two cases.

CalPERS then argues that *Mission* is irrelevant because it does not mention the predecessor to section 903 of the Bankruptcy Code.[66] This is a head scratcher. "A state cannot rely on the § 903 reservation of state power to condition or to 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 II*, 478 B.R. at 16. That was the fatal flaw of the Texas statute at issue in *Mission* and it is the fatal flaw of section 20487 here.

Finally, CalPERS asserts that the Court should ignore *Mission* because the Fifth Circuit's "30,000-foot approach to preemption" – whatever that means – "is not the law today."[67] The Court thoroughly covered the modern law of preemption – as applied in bankruptcy cases – in *Stockton II* and reached precisely the same conclusion as did the Circuit. CalPERS is simply wrong that, had

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[65] CalPERS Pension Br. at 37.

[66] CalPERS Pension Br. at 37.

[67] CalPERS Pension Br. at 38.

the Circuit undertaken the analysis that CalPERS condescendingly asserts it should have, it "would have been compelled to come to a contrary result."[68]

- *Vallejo*. While futilely attempting to distinguish *Mission*, CalPERS denigrates or ignores the wealth of subsequent authority (just as it disregards the Court's prior decisions in this case) that builds on *Mission* and further compels the conclusion that section 20487 is invalid. Take *Vallejo I*. In that case, at the urging of the City of Vallejo (represented by Mr. Levinson, Mr. Hile and other lawyers now representing the City), Judge McManus concluded that California labor law restricting the debtor's ability to reject 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). After thoroughly canvassing the law of federal preemption, District Judge Mendez affirmed that conclusion. *Vallejo II*, 432 B.R. at 268-70 ("incorporating state labor law is, as the Bankruptcy Court so found, prohibited by the Supremacy Clause, the Uniformity [Bankruptcy] Clause and the Contracts Clause"). In the face of that compelling precedent by "a court that has appellate jurisdiction over bankruptcy matters in this district,"[69] CalPERS ignores Judge Mendez entirely and asserts only that Judge McManus' conclusions are "wrong" and "particularly troubling."[70]

- *County of Orange*. Similarly, in *County of Orange*, Judge Ryan considered whether another provision of the California Government Code – section 27100.1 – was enforceable in a chapter 9 case. Section 27100.1 purported to impose a trust over certain funds held by municipalities. Judge Ryan observed that, just like section 20487, the California Legislature had enacted section 27100.1 in response to a potential bankruptcy filing by one of the State's municipalities. *County of Orange*, 191 B.R. at 1016 ("The California state legislature passed

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[68] CalPERS Pension Br. at 38.

[69] *In re Gire*, 107 B.R. 739, 743 (Bankr. E.D. Cal. 1989)

[70] CalPERS Pension Br. at 5, 15.

§ 27100.1 in response to concerns expressed when Butte County considered filing bankruptcy."). He then held that the statute conflicted with federal bankruptcy law and was preempted: "To the extent that § 27100.1 was intended to eliminate tracing when a debtor trustee is insolvent, it conflicts with federal bankruptcy law. . . . When a state law conflicts with federal bankruptcy law, the state law is preempted." *Id.* at 1016-17. Simply put, "[t]he California legislature cannot rewrite bankruptcy priorities," *id.* at 1017, a point Judge Ryan held to be "universally recognized by the courts and legal scholars," *id.* at 1017 n.13.

Judge Ryan's analysis did not stop there. He also rejected the argument that section 903 "prevents this court from preempting § 27100.1," *id.* at 1017, which is precisely the contention that CalPERS makes now:

> 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. *See* U.S. CONST., art. I, § 8.
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> Reserving to bankruptcy law the setting of priorities in chapter 9 does not unnecessarily impinge on states' rights or the ability of a municipal debtor to provide important services to the public. Nor does this principle conflict with Code § 903, which reserves to the state the power to control the municipal debtor in the exercise of its political or governmental powers. . . .
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> Furthermore, pursuant to Code § 109(c)(2), a municipal debtor must be specifically authorized by state law to file a chapter 9. *See* 11 U.S.C. § 109(c)(2). Cal. Gov. Code § 53760 specifically authorizes counties in California to file a chapter 9 case. *See* Cal. Gov't Code § 53760). 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. The right to discharge is not a benefit without burdens. . . .
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> Chapter 9 does not permit individual states to override the priority scheme that is inherent in the Code. A uniform bankruptcy code necessitates that federal law control creditor priorities. States voluntarily agree to permit their counties to file chapter 9. . . . It is equally clear that the Bankruptcy Act of 1978 explicitly defined the order of creditor priority and declared the congressional intent of federal supremacy over declared but conflicting state law.

County of Orange, 191 B.R. at 1020-21 (quotations omitted). Remarkably, CalPERS ignores *County of Orange* in its entirety.

- *Columbia Falls*. CalPERS also ignores the *Columbia Falls* case decided within the Ninth Circuit and cited in *County of Orange*. There, like here, a creditor argued that section 903 obligated a chapter 9 debtor to abide by a state statute requiring that certain bondholders be unimpaired and paid in full. The court rejected that argument:

> The language of 11 U.S.C. § 903 does not prevent the obligations to the bondholders from being impaired in bankruptcy. Section 903 provides Chapter 9 cannot "impair the power of a State to control, by legislation or otherwise, a municipality." However, no municipality may seek the protection of the federal bankruptcy laws without statutory authorization by the state. The Montana statute permit[s] municipalities to file under Chapter 9 . . . .
>
> Had the Montana Legislature sought to require municipalities to pay all of their debts in full, regardless of the cost to city services, it could have merely refused to permit municipalities to file Chapter 9 petitions by not enacting the enabling legislation required by Section 109(c)(2). As has been well stated:
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> > If a municipality were required to pay prepetition bondholders the full amount of their claim with interest as contained on the face of the bonds and the [debtor] had no ability to impair the bondholder claims over objection, the whole purpose and structure of Chapter 9 would be of little value. State law already requires full payment of the bonds issued prepetition and the state and the municipality are forbidden the opportunity to compromise the amounts due, without 100 percent consent of the bondholders. To create a federal statute based upon the theory that federal intervention was necessary to permit adjustment of a municipality's debts and then to prohibit the municipality from adjusting such debts is not, in the point of view of this Court, a logical or necessary result.
>
> Far from interfering with the ability of the state . . . to control its municipalities, it is concluded . . . [that the state] has affirmed that its municipalities may avail themselves of the benefits of the federal bankruptcy process, including the modification and termination of these sorts of debts, and such does not interfere with the power of the state . . . to control a municipality or in the exercise of the political or governmental powers of such municipality.

In re City of Columbia Falls, Mont., Special Improvement Dist. No. 25, 143 B.R. 750, 759-60 (Bankr. D. Mont. 1992) (emphasis added) (footnotes, citations, and quotations omitted).

- *City of Detroit*. Finally, CalPERS fails to confront the recent decision in *In re City of Detroit*, 504 B.R. 97 (Bankr. E.D. Mich. 2013), which is directly on point. In *Detroit*, Judge Rhodes rejected the argument – repackaged here by CalPERS – that "if chapter 9 permits the State of Michigan to authorize a city to file a petition for chapter 9 relief without explicitly providing for the

protection of accrued pension benefits, the Tenth Amendment is violated." *Id.* at 149-50. Relying extensively on the Court's analysis in *Stockton II*, Judge Rhodes held:

> The state constitutional provisions prohibiting the impairment of contracts and pensions impose no constraint on the bankruptcy process. The Bankruptcy Clause of the United States Constitution, and the bankruptcy code enacted pursuant thereto, explicitly empower the bankruptcy court to impair contracts and to impair contractual rights relating to accrued vested pension benefits. Impairing contracts is what the bankruptcy process does.
>
> The constitutional foundation for municipal bankruptcy was well-articulated in *Stockton* . . . .
>
> For Tenth Amendment and state sovereignty purposes, nothing distinguishes pension debt in a municipal bankruptcy case from any other debt. If the Tenth Amendment prohibits the impairment of pension benefits in this case, then it would also prohibit the adjustment [of] any other debt in this case. *Bekins* makes it clear, however, that with state consent, the adjustment of municipal debts does not impermissibly intrude on state sovereignty. *Bekins*, 304 U.S. at 52. This Court is bound to follow that holding.

Id. at 150 (emphasis added) (quotation of *Stockton II* omitted).

CalPERS says only that *City of Detroit* "rests on a misreading of the relevant Supreme Court decisions."[71] This does nothing other than back-handedly criticize the Court's analysis in *Stockton II*, which formed the basis for Judge Rhodes' conclusions.

* * *

For all of these reasons, section 20487 of the California Government Code does not and cannot operate to prohibit the City from rejecting or terminating its contract with CalPERS and thereby liquidating whatever liability it may have for unfunded prepetition pensions.

D. The Bankruptcy Code Permits Impairment Of Any Liability Arising From The City's Termination Of Its CalPERS Relationship.

Throughout CalPERS' eighty-seven pages of briefing there is an implicit – although curiously not explicit – assertion that California law, specifically the PERL, prohibits the impairment of vested pension benefits. This is not correct. The PERL anticipates pension benefit impairment. Moreover, to the extent that the PERL or any other State law did prohibit impairment, that law

[71] CalPERS Pension Br. at 14.

would be preempted and invalid in this case, just as the specific statute on which CalPERS actually relies (section 20487) is preempted and invalid.

1. There Is No State Policy Prohibiting Impairment Of Pension Benefits.

The basic premise of CalPERS and its organized labor allies is that the pension benefits the City promised to pay prior to bankruptcy are sacrosanct under California law and cannot possibly be modified, adjusted, or impaired in this case. However, when one peels back the onion and reviews the actual provisions of the PERL, it becomes clear that this core theory is unsupportable.

To start, consider the role of CalPERS. By its own admission, CalPERS does nothing more than "exercis[e] a governmental function in administering the Public Employees' Retirement Fund."[72] It is "the administrator of the statewide pension system for the State of California"[73] and, by its account, "tasked with protecting the System."[74] Nothing more. CalPERS deems this administrative function to be a "core governmental function"[75] – a highly-debatable proposition. As the Court observed on July 8, "CalPERS is, in effect, kind of a servicing agency."[76]

Whatever the label, CalPERS clearly is the not the protector of all public employee retirement benefits. Instead, state law authorizes a variety of retirement system options for municipal employers and, as noted above, the California Legislature specifically encourages employers to pursue alternatives to CalPERS pensions. CAL. GOV'T CODE § 20485. Municipalities are not, and have never been, required to participate in CalPERS. Rather, they are given the option to contract with CalPERS for pension administration services. Some do and others (such as the Cities of Fresno, Los Angeles, San Diego and San Jose) do not.[77] In fact, a full twenty of fifty-eight

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[72] CalPERS Plan Br. at 3.

[73] CalPERS Plan Br. at 10.

[74] CalPERS Pension Br. at 16.

[75] CalPERS Plan Br. at 6.

[76] Comp. 153 [7/8/14 Tr. at 40:2].

[77] Websites regarding the independent pension plans for those cities can be viewed here: http://lacers.org/ (Los Angeles); https://www.sdcers.org/ (San Diego); http://sjretirement.com/ (San Jose); http://www.cfrs-ca.org/ (Fresno).

California counties have established their own retirement systems.[78] If anything, the CalPERS system and the PERL represent a clear decision by the State not to establish a compulsory and uniform statewide system for municipal retirement.

Most importantly, however one describes the role of CalPERS, it cannot be said that California law prohibits the adjustment or impairment of pension benefits. To the contrary, the PERL expressly contemplates that benefits will be reduced in the event a member agency terminates its contract with CalPERS and is unable to make the termination payment called for under the statute. The "system" that CalPERS fights so hard to protect includes a member's ability to terminate and circumstances in which benefits are cut.

Thus, should the City terminate its relationship with CalPERS and discharge the claim for termination liability arising under the PERL, there is no harm to the State – monetary or otherwise. The result would be a reduction in pension benefits without any diminishment in funds held by CalPERS for the benefit of other pension beneficiaries, precisely that which the PERL contemplates and implements. The sovereign interests of the State are not offended by this in the least.

2. The Bankruptcy Code Preempts Any Requirement That The City Fully Satisfy Its Termination Liability Under The PERL.

Given this, there is no colorable argument that impairment of the claim for termination liability offends the Tenth Amendment, section 903 of the Bankruptcy Code or any other applicable law. Upon termination by the City, CalPERS would have a claim for termination liability. When that claim is impaired and discharged in bankruptcy, CalPERS effectively would pass along the impairment to pension beneficiaries by reducing benefits in accordance with the PERL, with no harm to the State or other CalPERS pensioners.

[78] According to CalPERS, the following are "'37 Act" counties that do not participate in the CalPERS system: Alameda, Contra Costa, Fresno, Imperial, Kern, Los Angeles, Marin, Mendocino, Merced, Orange, Sacramento, San Bernardino, San Diego, San Joaquin, San Mateo, Santa Barbara, Sonoma, Stanislaus, Tulare, and Ventura. http://www.calpers.ca.gov/index.jsp?bc=/member/service-credit/purchase-options/redeposit/recipretiresystems.xml&pst=IN&pca=PA (last visited Aug. 29, 2014).

The statute requiring the City to pay the termination claim to CalPERS is no different than the statute in *Mission* (requiring the municipality to pay bonds held by the state), the statute in *County of Orange* (requiring the municipality to hold funds in trust for other municipalities), the laws in *Vallejo* (prohibiting termination of collective bargaining agreements) or, perhaps most notably, the state constitutional provisions in *City of Detroit* (providing that accrued pensions "shall not be diminished or impaired"). It merely provides for the City to pay a liquidated sum to CalPERS. If anything, given CalPERS' ability under the PERL to immunize itself from losses due to the City's impairment of the termination claim, preemption here is far less offensive to legitimate interests of the State than the outcome of those other cases.

Having authorized the City to file for bankruptcy, the State (through CalPERS) cannot now neuter the City's ability to comply with the Bankruptcy Code by proposing a plan of adjustment that meets the Code's confirmation requirements. Those requirements include fair, equitable and nondiscriminatory treatment of creditors – something that, as Franklin has demonstrated, requires the City's unfunded prepetition pension liabilities to be impaired and adjusted. There is nothing remotely objectionable, much less unconstitutional, about this.[79]

3. Section 943(b)(4) Of The Bankruptcy Code Does Not Require The City To Pay The Termination Claim.

After failing with its Tenth Amendment argument, CalPERS argues that "[a]n attempt by a municipal debtor to alter its obligations to CalPERS through the confirmation of a plan of adjustment that does not comply with State law would run counter to section 943(b)(4) of the Bankruptcy Code."[80] Specifically, CalPERS cites section 20831 of the California Government Code, which states that no contracting agency shall "fail or refuse to pay the employers' contribution required by" the PERL, and asserts that "a municipal debtor's plan would violate section 943(b)(4)

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[79] CalPERS appears to argue that the entirety of chapter 9 is unconstitutional. In *City of Detroit*, Judge Rhodes rejected multiple challenges to the constitutionality of the statute, concluding that chapter 9 does not violate the Tenth Amendment and that *Bekins* remains good law. *City of Detroit*, 504 B.R. at 138-49. Franklin refers to that persuasive analysis here in response to any suggestion that the Court is overseeing a case conducted under an unconstitutional statute.

[80] CalPERS Pension Br. at 16.

to the extent it proposed to adjust its payments to CalPERS in contravention of the PERL through a plan of adjustment."[81]

CalPERS misreads the Code. Section 943(b)(4) merely requires that, as a condition to confirmation, the court find that "the debtor is not prohibited by law from taking any action necessary to carry out the plan." 11 U.S.C. § 943(b)(4). As the City correctly notes, "[t]his section is intended to prevent chapter 9 debtors from using the bankruptcy court for the purpose of circumventing compliance with state law after confirmation."[82]

Specifically, section 943(b)(4) only "applies to postpetition actions after confirmation of the plan." *Columbia Falls*, 143 B.R. at 760 (emphasis added). Thus, for example, a municipal debtor cannot "issue bonds as part of a plan that will not conform to all state law requirements for such bonds." *Id.*; *see In re City of Colo. Springs Spring Creek Gen. Imp. Dist.*, 177 B.R. 684, 694 (Bankr. D. Colo. 1995) (debtor required to follow state law governing bonds to be issued pursuant to plan of adjustment). Section 943(b)(4), however, does not restrict the impairment of debt under the plan itself, even where such impairment violates state law. *Columbia Falls*, 143 B.R. at 760 ("It does not, however, restrict the ability of the debtor to impair prepetition bonds so long as the other requirements of Chapter 9 are met.").

Thus, as COLLIER summarizes, under section 943(b)(4) "the debtor may take action or enter into transactions under the plan itself as necessary to adjust its debts without regard to state law, except for any required regulatory or electoral approval, but once the plan is confirmed and put in place, the debtor may not do things that are prohibited by state law. In other words, the confirmation of a chapter 9 plan does not exempt a municipality from future compliance with state law." 6 COLLIER, *supra*, ¶ 943.03[4] (emphasis added) (footnote omitted).

Section 943(b)(4) does not resuscitate the preempted State law on which CalPERS relies.

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[81] CalPERS Pension Br. at 16-17.

[82] *City's Memorandum Of Law In Support Of Confirmation* [D.I. 1243] at 19 (emphasis added).

4. Pension Claims Are Not Property Rights.

Finally, citing nothing, certain union groups suggest that "vested pension rights are property rights [that] cannot be impaired."[83] The PERL itself disposes of this argument, as it permits reduction in benefits (*i.e.*, impairment) upon a contracting agency's failure to make the termination payment. That would not be possible if beneficiaries had immutable property rights.

Moreover, the labor advocates concede that, "[i]n all the cited decisions, the courts referred to pension rights of public employees as 'vested contractual rights.'"[84] As the Court has observed, "[t]he goal of the Bankruptcy Code is adjusting the debtor-creditor relationship. Every discharge impairs contracts. While bankruptcy law endeavors to provide a system of orderly, predictable rules for treatment of parties whose contracts are impaired, that does not change the starring role of contract impairment in bankruptcy. It follows, then, that contracts may be impaired in this chapter 9 case without offending the Constitution." *Stockton II*, 478 B.R. at 16; *see City of Detroit*, 504 B.R. at 153-54 ("[T]he only remedy for impairment of pensions is a claim for breach of contract. Because under the Michigan Constitution, pension rights are contractual rights, they are subject to impairment in a federal bankruptcy proceeding.").

* * *

As a consequence, there is nothing about a claim for unfunded prepetition benefits that provides immunity from discharge or impairment in this case.[85]

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[83] Union Br. at 15; *see* Retiree Br. at 9; PORAC Br. at 12-14.

[84] Union Br. at 15 (emphasis added).

[85] Grasping at straws, *amicus* PORAC asserts that pensions are immunized by provisions of the PERL and the California Code of Civil Procedure that prohibit benefits from being assigned and attached by creditors. PORAC Br. at 13-14. Those provisions only protect benefits "under this part" (the PERL), CAL. GOV'T CODE § 21255, which specifically contemplates reduction upon a contracting agency's termination. Moreover, protection against levy or execution does nothing to elevate a creditor's rights above the rights of others in the distribution of a debtor's assets.

III. THERE IS NO LEGAL OR FACTUAL JUSTIFICATION FOR THE CITY'S ASSUMPTION OF PREPETITION PENSION LIABILITIES

Unlike CalPERS, the City does not contend that it is unable to impair and adjust its massive liability for unfunded prepetition pension benefits. Rather, the City simply chooses not to do so.[86] It defends itself by claiming that it has acted in "in good faith" and "has no better choice than the one it has made."[87]

As summarized in Section III.B, below, the evidence (contrasted with the self-interested speculation of the City and its labor allies) is to the contrary. More importantly, the City's entire argument proceeds on the assumption that there is a "good faith" or "business judgment" exemption from the Bankruptcy Code's statutory prerequisites to confirmation. There is not.

A. There Is No "Good Faith" Or "Business Judgment" Exemption From The Bankruptcy Code's Confirmation Requirements.

The major theme of the plan supporters is that the City has acted in good faith, with no viable alternative other than capitulating to CalPERS, and that any impairment of pensions would have a "devastating impact" on pensioners who already have made "major concessions."[88] Yet, despite all the ink spilled over the alleged need to favor CalPERS and employees, the supporters say next to nothing about the core issues in this case: whether, in providing a recovery of less than 1% to Franklin while paying pensions in full, the Plan meets the "best interests of creditors" standard established by section 943(b)(7) and satisfies the requirements of section 1129(b) by providing fair, equitable, and not unfairly discriminatory treatment to Franklin.

Those statutory provisions are the rules of the game. They cannot be dismissed as "somewhat mechanical"[89] and they are not optional. In requiring that the City adhere to the Bankruptcy Code, the Court would not be "substitut[ing] its judgment in place of the debtor's

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[86] City Br. at 26 ("the City takes no position").

[87] City Br. at 14.

[88] City Br. at 3-22; Retiree Br. at 4-7; SPOA Br. at 3-13; Union Br. at 6-10.

[89] Union Br. at 11.

political and governmental judgment" as the unions absurdly suggest.[90] To the contrary, the Court would be doing its job, as satisfaction of the statutory conditions to confirmation "is mandatory." *In re W.R. Grace & Co.*, 475 B.R. 34, 173 (D. Del. 2012); *In re H.H. Distributions, L.P.*, 400 B.R. 44, 50 (Bankr. E.D. Pa. 2009); *In re Laurel Glen Apartments of Acworth, Ltd.*, 139 B.R. 199, 201 (Bankr. S.D. Ohio 1991). The Court has an independent duty – "somewhat amplified in Chapter 9" – to assure itself that the Plan satisfies those mandatory requirements.

1. The Plan Fails The Best Interests Test, In Part Because It Leaves Pensions Untouched While Cramming Down A Sub-1% Recovery On Franklin.

Franklin has demonstrated that the Plan fails section 943(b)(7) because the City has the ability pay vastly more than 1% on Franklin's unsecured claim, particularly in light of the City's wholesale unimpairment of its much larger prepetition liability for unfunded pensions.[91]

Mr. Moore's expert report and persuasive testimony put to rest any notion that the City cannot "afford" to pay Franklin.[92] The City simply chooses not to do so, and has rigged the game through the "living" Long-Range Financial Plan – a forecast the City feels free to revise whenever "inspiration strikes"[93] – which devours every single surplus dollar available to the City through hypothetical "mission critical" expenses that the City could not even identify, much less quantify.[94] At trial, Mr. Leland, the primary architect of the Long-Range Financial Plan, conceded that "mission critical" is just a fancy name for a plug number, as it represents every penny in excess of the City's cash reserve target, which itself is an arbitrary figure.[95]

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[90] Union Br. at 13-14.

[91] *See* Franklin's *Summary Objection* [D.I. 1273] ("Obj. I") at 8-30 and Franklin's *Supplemental Objection* [D.I. 1377] ("Obj. II") at 2-24.

[92] Comp. 295-96 [Expert Report of Charles Moore (Trial Ex. 2967) ("Moore Rep.") at 3-4]; Comp. 106-07 [5/14/14 Tr. at 91:20-92:4 (Moore)].

[93] Comp. 28-29 and 33-35 [5/12/14 Tr. at 116:5-117:3 and 133:16-135:14 (Leland)].

[94] In fact, the City already has manipulated its forecast to keep money from Franklin. After performing better than forecast in the latter part of 2013 and the first quarter of 2014, the City revised the Long-Range Financial Plan to account for the increased revenues, but then mysteriously reduced its revenue forecasts in the third decade of the forecast so that there would be no funds "available" to pay Franklin. Comp. 327 [Trial Ex. 2971]; Comp. 205-20 [Trial Ex. 2016]; Comp. 222-31 [Trial Ex. 2017]; Comp. 71-75 [5/14/14 Tr. at 33:19-37:2 (Moore)].

[95] Comp. 30-32 [5/12/14 Tr. at 122:16-124:14 (Leland)].

The City's assertion that it has no cash to spare is not credible. This was demonstrated after trial when, notwithstanding its prior pronouncement that it could not possibly devote more than $350,000 to payment of Franklin's claim, the Court valued Franklin's collateral and the City found enough cash to pay Franklin more than $4 million on the Plan effective date. The evidence at trial confirmed that the City has plenty of additional resources with which to pay Franklin more than $305,000 (0.93578% on Franklin's remaining unsecured claim) over the thirty years of the forecast period and beyond. In particular –

- The Long-Range Financial Plan. The Long-Range Financial Plan is conservative, as the document reflects in multiple places.[96] In preparing the forecast, Mr. Leland took already "discounted" revenue projections provided by City staff and reduced them in order to be "conservative."[97] Those conservative revenue projections are well below the City's historical average growth rates[98] and, given the strong winds of recovery outlined by Mr. Chin,[99] it is highly likely that the City will do better than the conservative forecast predicts. Indeed, the City admits that variances in the projections are more likely to be "good news" than "bad news."[100] If the City averages just a half-percent better than forecast, the City will generate nearly an extra half billion dollars over the forecast period.[101]

Even as forecast – ***including assumption and payment of all prepetition pension liabilities*** – the City builds ample cash with which it could pay Franklin. By the end of the Long-Range Financial Plan in 2041, the City projects that it will have $58 million in cash on hand, plus an additional $56 million in unused "contingency" funds, and will have spent $236 million of surplus

[96] Comp. 193-95 [Trial Ex. 2006 (Long-Range Financial Plan) ("LRFP") at 1-3].

[97] Comp. 36-37 [5/12/14 Tr. at 139:2-140:10 (Leland)].

[98] Comp. 296-97 [Moore Rep. at 4-5]; Comp. 66-70 [5/14/14 Tr. at 26:14-30:13 (Moore)]; Comp. 323-25 [Trial Ex. 2970].

[99] Comp. 314-21 [Expert Report of Frederick Chin (Trial Ex. 2968) at 24-31]; Comp. 130-36 [5/15/14 Tr. at 22:4-28:18 (Chin)].

[100] Comp. 194, 195 [LRFP at 2, 3].

[101] Comp. 195 [LRFP at 3].

cash on unidentified "mission critical" expenses[102] plus an additional $123 million to subsidize "entertainment venues" like the Arena, Ice Rink, Ballpark and Theater.[103] Extending the forecast out to 2053 – the period to which the City proposes to restructure the Pension Obligation Bonds – results in a cash balance of $179 million plus $80 million in unused contingency funds, with the City having spent $824 million in surplus cash on the hypothetical "mission critical" expenditures.[104]

Given this, regardless of the level of minimum cash balance the City seeks to maintain, there will be ample funds available to pay Franklin in full.[105] Under the Plan, the City devotes not a single dollar of those funds to pay Franklin, while it simultaneously provides for full payment of the unfunded prepetition pension liabilities that constitute the largest unsecured claim in the case. This plainly does not satisfy the rigors of section 943(b)(7).

- Public Facility Fees. The City also could pay Franklin from public facility fees (PFFs) but chooses not to do so. The evidence is clear that PFFs – which are restricted funds – can be used to pay Franklin. Indeed, the City sold Franklin's bonds on the premise that PFFs would provide the entirety of debt service,[106] and S&P gave the bonds an "A" rating as a consequence of that premise.[107] During the pre-bankruptcy neutral evaluation process, the City proposed to pay Franklin with future PFF revenues that it valued as a recovery of 55%,[108] and during the bankruptcy case City staff stated that it would "be seen as a sign of bad faith" if the City failed to devote PFFs to payment of Franklin's bonds.[109] The City's belated assertion that "restricted funds . . . are not available to [pay] Franklin's claims" is not credible.[110]

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[102] Comp. 329 [Trial Ex. 2973]; Comp. 76-82 [5/14/14 Tr. at 38:12-44:16 (Moore)]; Comp. 297-301 (Moore Rep. at 5-9)].

[103] Comp. 303 (Moore Rep. at 13); Comp. 88-89 [5/14/14 Tr. at 59:20-60:13 (Moore)].

[104] Comp. 329 [Trial Ex. 2973]; Comp. 76-82 [5/14/14 Tr. at 38:12-44:16 (Moore)]; Comp. 300-01 (Moore Rep. at 8-9)].

[105] Comp. 331 [Trial Ex. 2974]; Comp. 83-84 [5/14/14 Tr. at 45:10-46:11 (Moore)]; Comp. 301 (Moore Rep. at 9) (Tables 2A and 2B)].

[106] Comp. 334 [Trial Ex. 3050 at A-8].

[107] Comp. 278 [Trial Ex. 2628].

[108] Comp. 190-91 [Trial Ex. 1376 (Ask) at 44-45].

[109] Comp. 240 [Trial Ex. 2023 at 8]. Mr. Chase, who was hired postpetition, initially claimed that no PFFs could be used to repay Franklin, but later conceded that PFFs would be available after

While greatly diminished from the pre-recession peak, the City continues to generate PFF revenues, which will increase over time as the City's housing market recovers. In fact, the City's consultants project a sustained long-term average of 700 single family residence permits per year,[111] which would produce far more than enough PFF revenue to pay Franklin in full. Even with new home sales at current levels, PFFs generate more than $1 million a year that could be devoted to repayment of Franklin, and new home permits of just several hundred units per year would be sufficient to pay a large portion of the debt service on Franklin's bonds.[112]

Yet, the Plan devotes no future PFFs to pay Franklin's claim. None. Instead, the City keeps them all for itself.[113] If it insists on assuming its much larger liability for unfunded prepetition pensions, the City cannot satisfy the "best interests" test without also devoting a fair portion of future PFF revenues toward repayment of Franklin's claim.

Neither the City nor the other plan supporters address the City's obvious ability to pay Franklin. At best, they imply that the collective welfare of the City's creditors is adequate to satisfy section 943(b)(7). Franklin conclusively refuted that suggestion in its pre-trial briefing. Chapter 9's "best interests" test provides a fundamental baseline of protection to each and every individual dissenting creditor, just as it does in chapter 11.[114] None of the plan supporters has shown otherwise.

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payment of certain short-term expenditures – about 340 permits worth. Comp. 44 [Tr. 5/13/14 at 107:14-23 (Chase)].

[110] City Br. at 24-25.

[111] Comp. 234-37 [Trial Ex. 2021]; Comp. 196 [LRFP at 4].

[112] Comp. 302 [Moore Rep. at 11 (Table 4)]; Comp. 85-87 [5/14/14 Tr. at 56:2-58:8 (Moore)].

[113] Incredibly, the City has used PFFs to pay the fees of its bankruptcy professionals, on the theory that expenses incurred in attempting the cram the Plan down on Franklin are legitimate costs to build out the projects that Franklin actually funded (while repayment of Franklin itself apparently is not). Comp. 257-66 [Trial Ex. 2070]; Comp. 268-69 [Trial Ex. 2071]; Comp. 23-24 [5/12/14 Tr. at 87:3-88:21 (Burke)].

[114] Obj. I at 9-11; Obj. II at 3-6.

2. The Plan Unfairly Discriminates Against Franklin, In Part Because Pensions Are Paid In Full While Franklin Is To Receive Less Than 1%.

Franklin's second fundamental objection to confirmation is the discriminatory nature of the Plan, which seeks to pay Franklin less than 1% of its allowed unsecured claim while paying prepetition pensions in full and providing recoveries of 52% to 100% to other unsecured creditors.[115]

The City favors those other creditors without any legitimate basis for doing so. For example, the City never valued or appraised the collateral that purportedly secures the Ambac bonds, the National bonds and Assured's 400 East Main bonds. As Mr. Toppenberg admitted, "[t]he City has not appraised any of these properties."[116] The Pension Obligation Bonds are wholly unsecured, as are the claims of the retirees. Yet, in each case, the City seeks to pay the holders of those claims 52% or more. The City even satisfied all of its prepetition trade debt during the bankruptcy case, so that it could "focus" the restructuring on "unsustainable long term debt."[117]

This is textbook unfair discrimination. The City knows this, so it tries to remove the issue of unfair discrimination from the discussion, arguing that Franklin has no standing to invoke the cram down protections of section 1129(b) because Class 12 voted to accept the Plan.[118] This is too facile.

As Franklin demonstrated,[119] the City gerrymandered Class 12 specifically to avoid the unfair discrimination test. *See, e.g.*, *In re Barakat*, 99 F.3d 1520, 1525 (9th Cir. 1996) ("if the classifications are designed to manipulate class voting . . . , the plan cannot be confirmed") (quoting *In re Holywell Corp.*, 913 F.2d 873, 880 (11th Cir. 1990)). In particular, after separately classifying virtually every other unsecured claim, including the unsecured Pension Obligation Bonds, the City classified Franklin's claim together with the health care claims of retirees who agreed to accept an artificially low recovery in Class 12 in exchange for payment in full of their unfunded pension

[115] Obj. I at 30-51; Obj. II at 24-38.

[116] Comp. 342 [Direct Testimony Declaration Of Val Toppenberg [Trial Ex. 3067] at 8]; Comp. 40-41, 42, 43 [5/13/14 Tr. at 68:20-69:1, 70:10-14, 71:13-17 (Toppenberg)].

[117] Comp. 252-55 [Trial Ex. 2065]; Comp. 25-27 [5/12/14 Tr. at 95:2-97:3 (Burke)].

[118] City Br. at 26.

[119] Obj. I at 32-41; Obj. II at 25-29.

benefits.[120] Taken together, the retirees stand to recover well over 50% on their prepetition claims (pensions and health benefits) against the City.[121] Franklin, on the other hand, gets no corresponding benefit to accompany the sub-1% recovery on its unsecured claim. It gets a 1% cram down and nothing more. This disparate treatment – resulting from illegal gerrymandered classification – violates the "same treatment" rule of section 1123(a)(4) of the Bankruptcy Code.[122]

In any event, section 1129(b)'s prohibition on unfair discrimination is not so easily evaded.[123] Considerations of unequal classification, disparate treatment and unfair discrimination work together to achieve the Bankruptcy Code's fundamental goal of equality of treatment:

> [S]eparate classification, when coupled with materially different economic treatment of the classes, can have the effect of unfair discrimination among similarly situated creditors. Classes may, by voting for the plan, accept the different treatment, but courts should be cautious about carrying this reasoning too far. Although the "unfair discrimination" standard technically applies only under section 1129(b) when a class has not accepted the plan, a court should consider a confirmation objection based on alleged improper classification raised by a dissenting creditor in an accepting class if the combination of separate classification and materially different treatment results in substantially different economic effects between the two classes and the purpose and effect is other than the debtor's good faith effort to protect its future business operations.

7 COLLIER, *supra*, ¶ 1122.03[3][a] (emphasis added) (citation omitted); *see, e.g.*, *In re Corcoran Hosp. Dist.*, 233 B.R. 449, 455 (Bankr. E.D. Cal. 1999) ("in determining whether a separate

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[120] Payment in full of retiree pensions was an integral, inextricable component of the Retirees Settlement that resulted in the retirees' acceptance of the Plan. Comp. 242-45 [Trial Ex. 2045]; Comp. 247-50 [Trial Ex. 2052]; Comp. 271-73 [Trial Ex. 2610]; Comp. 275 [Trial Ex. 2613]. The City now concedes that "any impairment of pensions would also unravel . . . its penny on the dollar settlement with the Retirees Committee." City Br. at 22; *see* Retiree Br. at 4-5; SPOA Br. at 12 13 ("The Retirees' Committee and the City negotiated a settlement, now incorporated in the Plan, allowing the elimination of their health care benefits in exchange for, and contingent upon, retention of their CalPERS pensions.") (emphasis added).

[121] Comp. 197 [LRFP at 11]; Comp. 306 [Moore Rep. at 17]; Comp. 90; 94-96 [5/14/14 Tr. at 63:1-24; 67:7-69:25 (Moore)]. Notably, in the Retirees Settlement the City inflated the actual amount of retiree health care claims by more than 100%, from roughly $262 million to more than $546 million, by failing to discount its future liabilities to present value. Comp. 304-06 [Moore Rep. at 15-17]; Comp. 90-94 [5/14/14 Tr. at 63:25-67:6 (Moore)]; Comp. 45-55 [5/13/14 Tr. at 144:9-154:5 (Goodrich)]. This was done to depress Franklin's "pro rata" distribution as much as possible. For more on this issue, *see* Obj. I at 60-63; Obj. II at 40-44.

[122] Obj. I at 41-46; Obj. II at 29-32.

[123] Obj. I at 30-32; Obj. II at 24-25.

classification under § 1122(a) and, similarly, treatment of separate classes under § 1123(a)(1) through (4) is appropriate, courts must be guided by the mandate of § 1129(b)(1) that the plan not discriminate unfairly with respect to a class of creditors that is impaired under the plan and has not voted to accept the plan").

In ruling on eligibility, the Court observed that the issue of unfair discrimination would be front and center if the City persisted in proposing a plan that left unfunded pension liabilities unimpaired: "If a plan is proposed that does not deal with CalPERS and if the Capital Market Creditors reject their treatment under the proposed plan, then I will have to focus on the question of unfair discrimination. . . . And the City is going to have a difficult time confirming a plan over an objection and claim of unfair discrimination without being able to explain that problem away."[124] The City cannot explain the problem away. Comparing the favorable treatment of pensions and all other material creditors to the 1% the City wants to cram down on Franklin, the Plan plainly violates the fundamental goal of equality and unfairly discriminates against Franklin.

B. Assumption Of The City's Massive Prepetition Liability For Unfunded Pensions Is Neither Prudent Nor Required Under The Circumstances.

Even if there were a "business judgment" exception to the Bankruptcy Code's confirmation requirements, the City's decision to assume its unfunded prepetition pension liability is neither prudent nor supported by a legitimate business justification. To the contrary, it is reckless.

1. This Case Presents The City's Only Opportunity To Confront Its Pension Problem.

The City's decision regarding pensions must be considered in an important context – this 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. ***The City must act now or not all***. This is not a can that can be kicked down the road, at least not unless the City anticipates another bankruptcy case in its future.

[124] Comp. 20 [4/1/13 Tr. at 590:11-23].

There is no debate on this point. As summarized in Section IV, below, if the City terminated its CalPERS contract without the protection of the Bankruptcy Code it would be saddled with an inflated claim for termination liability, potentially secured by a lien on all of its assets. The City proclaims that, "outside of bankruptcy, the City would have no option other than to continue making its pension payments because not doing so would invite CalPERS to terminate the pension plan, which would result in the CalPERS Lien attaching to all of the City's assets to secure payment of the immediate $1.6 billion termination liability."[125]

In bankruptcy, however, the City does have an "option." Unfortunately, the City has chosen to forgo its one-time opportunity to confront the irresponsible unfunded promises of the past, and instead seeks to assume them wholesale in this case. There is no defensible reason for it do to so.

2. The City's Pension Liabilities Are Out Of Its Control.

In contrast, there are good reasons for the City to act now to address its pension problem. By any measure, the City's projected annual payments to CalPERS are huge. In the Long-Range Financial Plan, the City projects that its annual payments to CalPERS will more than triple within a decade – from $14.14 million in Fiscal Year 2011-12 to $42.43 million in Fiscal Year 2020-21, and then climb to $54.13 million a decade later in Fiscal Year 2030-31.[126] By Fiscal Year 2019-20, pension payments will consume 18.5% of the City's general fund, with contributions to the safety plan comprising 57.1% of payroll according to CalPERS, well above the City's historical norm and the liabilities of comparable peer cities.[127]

One reason the City's pension contributions are high in relation to its peers is that, in the past, it enabled employees to turn "pension spiking into an art form" and thus get "much larger pensions for the rest of their lives."[128] ***By assuming all pension obligations, the City will cement those mistakes and have to shoulder the burden for the next half century***.

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[125] City Br. at 27.

[126] Comp. 198-203 [LRFP at CTY257707-CTY257712, line 52].

[127] Comp. 307-10 [Moore Rep. at 18-21]; Comp. 98-99 [5/14/14 Tr. at 72:6-73:10 (Moore)].

[128] Comp. 162 [Trial Ex. 410 at 1].

To make matters worse, the City's annual payments to CalPERS are unpredictable and completely out of the City's control. Mr. Lamoureux testified that CalPERS calls all the actuarial shots, and establishes assumptions with respect to discount rates, mortality, retirement patterns, demographic trends and the like.[129] Ms. Nicholl agreed.[130] This results in volatility and unpredictability. As Mr. Moore explained, the City's projected contribution rates to CalPERS have tended to increase year over year, making it difficult if not impossible to prepare responsible and accurate forecasts.[131] Just during this case, CalPERS already has changed its demographic assumptions, discount rate, asset allocations, and amortization and rate smoothing policies – in an effort, among other things, to recoup CalPERS investment losses of seven to eight years ago – with the result being higher projected contributions for the City toward its unfunded prepetition pension liability for the next twenty-five years.[132]

And make no mistake about it, CalPERS does not have the interests of the City at heart. This was illustrated, yet again, two weeks ago, when CalPERS thumbed its nose at Governor Brown and the State Legislature by voting to add nearly one hundred different categories of "extra" or "add" pay that will count toward pension calculations for employees hired after January 1, 2013.[133] Governor Brown issued a release stating that "CalPERS got it wrong" and noting that the new regulations "undermine[] the pension reforms enacted just two years ago."[134] The League of California Cities stated that it "is in complete agreement with the Governor's assessment"[135] and rating agency Fitch observed that CalPERS "exposes public employers to higher pension liabilities and contribution expenses, and appears to be a step backward from recent reforms."[136] Locally, the SACRAMENTO BEE bluntly noted in an editorial that CalPERS "would authorize pension spiking by

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[129] Comp. 118-19, 120 and 121 [5/14/14 Tr. at 195:9-196:2, 197:9-19, and 198:4-15 (Lamoureux)].

[130] Comp. 142-43 [6/4/14 Tr. at 44:6-45:6 (Nicholl)].

[131] Comp. 307-10 [Moore Rep. at 18-21]; Comp. 97-103 [5/14/14 Tr. at 71:11-77:18 (Moore)] .

[132] Comp. 119-23 [5/14/14 at 196:21-200:22 (Lamoureux)].

[133] *See* accompanying request for judicial notice ("RFJN"), Ex. A.

[134] RFJN, Ex. B.

[135] RFJN, Ex. C.

[136] RFJN, Ex. D.

another name,"[137] while nationally the WALL STREET JOURNAL editorialized: "Jerry Brown wanted to stop 'pension spiking.' So much for that."[138] Sadly, history repeats itself.

3. The City Did Not Consider Alternatives.

Despite its large and uncontrollable pension liability and the irresponsible stewardship of CalPERS, the City never seriously considered any course of action other than unimpairment and payment in full. During the eligibility trial, Mr. Deis testified that the City never explored alternatives to CalPERS prior to the petition date.[139] Ms. Goodrich conceded that she never "consider[ed] any pension reductions" in developing the pre-bankruptcy Ask,[140] and neither Ms. Haase nor Ms. Montes could recall the City performing any pre-bankruptcy analysis of alternatives.[141] It was only after filing for bankruptcy and facing objections to eligibility that the City began to develop a "business case" to support, in hindsight, its decision to pay all pensions.[142]

Why this lack of curiosity over ways to restructure the City's largest, most problematic liability? The view of the City, then and now, is that employees and retirees "have borne more than their share of the bankruptcy burden."[143] The City asserts that its "workforce already has shouldered a disproportionate share of cuts," pointing to (a) compensation cuts resulting from the collective

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[137] *Editorial: CalPERS Proposal Would Authorize Pension Spiking By Another Name*, SACRAMENTO BEE (Aug. 19, 2014), *available at* www.sacbee.com/2014/08/19/6637585/editorial-calpers-proposal-world.html.

[138] *Review and Outlook: CalPERS's Play For Pay*, WALL STREET JOURNAL (Aug. 26, 2014), *available at* http://online.wsj.com/articles/calperss-play-for-pay-1409009372.

[139] Comp. 7-9 [3/25/13 Tr. (Vol. I – A.M.) at 60:12-62:20].

[140] Comp. 171 [Trial Ex. 713 at 116:5-15] Comp. 56 [5/13/14 Tr. at 156:1-6 (Goodrich) ("Q. The boil down of the question is, did the City make a decision not to impair pensions before or as part of its settlement with retirees? A. Before. As I said, the City made that decision as part of its AB-506 preparation, and part of its agreements with the employer organizations at that time.")].

[141] Comp. 180-81 [Trial Ex. 719 at 88:15-89:13]; Comp. 165 [Trial Ex. 712 at 115:4-10].

[142] Comp. 12 and 13-14 [3/26/13 Tr. (Vol. II – P.M.) at 365:9-19 and 371:14-372:5 (Goodrich)]; Comp. 176-79 [Trial Ex. 719 at 82:20-85:11]; Comp. 172-73 [Trial Ex. 713 at 267:15-268:2].

[143] City Br. at 19; *see* SPOA Br. at 13 ("the real parties in interest who would be economically hurt by a cut in CalPERS pensions – the retirees and the current employees, including the police – have already made very significant concessions as part of the plan process").

bargaining agreements that the City negotiated immediately before and during the bankruptcy case, and (b) the retirees' agreement to accept impairment of their health benefit claims.[144]

The City's refusal to explore alternatives may have been influenced by the fact that employees who participated in the City's decision not to impair CalPERS, and three members of the City Council who ratified that decision, have CalPERS pensions.[145] Even if not, viewed objectively the concessions made by labor simply do not justify the Plan's treatment of Franklin. When compared to the 1% recovery for Franklin, the labor concessions are hardly "disproportionate." It is the other way around – Franklin is the party from whom a "disproportionate" concession is demanded.

Moreover, the "concessions" made by labor merely reduced "above market" pay and benefits to a "market" level,[146] and the new collective bargaining agreements relate to postpetition obligations. They say nothing about concessions made on account of the City's prepetition obligations, which have been paid in full with no concessions whatsoever.

The labor concessions also are temporary. All but one of the collective bargaining agreements that the City negotiated before and during this case have already expired and are subject to renegotiation now or in the near future,[147] with organized labor groups able to negotiate to recoup their prior concessions. The City actually anticipates this, as Chief Jones testified that officers are agitating to get "their previous 20-30% cuts restored."[148] Ephemeral temporary labor concessions intended to bring employee compensation to a market level simply are not comparable to the permanent 99+% impairment the City seeks to cram down on Franklin. The fact that the City renegotiates its collective bargaining agreements every year also disproves the City's assertion that it

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[144] City Br. at 19-20.

[145] Comp. 166, 167-68 [Trial Ex. 712 at 204:3-9, 205:21-206:16]; Comp. 184-85 [Trial Ex. 723 at 225:24-226:5].

[146] Comp. 159 [Trial Ex. 109 at 3] ("deep cuts to employee compensation and benefits in recent years . . . have left Stockton, for the most part, at the labor market average"); Comp. 186-87 [Trial Ex. 723 at 250:18-251:1].

[147] Comp. 166-67; 167-68 [Trial Ex. 712 at 204:3–205:7; 205:21–206:19].

[148] Comp. 339 [Direct Testimony Declaration of Eric Jones [Trial Ex. 3056] at 4].

must leave pension liabilities unimpaired lest it breach the agreements.[149] The City is free to negotiate new deals upon expiration of the existing agreements.

Similarly, while 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.

Accordingly, the concessions made by employees and retirees cannot serve as justification for the permanent 99% haircut the City seeks to impose on Franklin. While those concessions may be significant, they pale in comparison to the punitive treatment to be meted out on account of Franklin's allowed unsecured claim.

4. The City Has Alternatives To CalPERS.

The other major theme of the plan supporters is that the City has no choice but to leave pension liabilities unimpaired because there are no viable alternatives. The City says that, literally, "its only option is not to impair its pension obligations."[150] In particular, because there allegedly "is no viable, less costly alternative for the City,"[151] anything other than full capitulation to CalPERS would result in "large-scale departure of [the City's] employees."[152] Neither part of that assertion is supported by the evidence.

a. *Viable Alternatives Exist*.

There is no doubt that it would be a difficult, potentially painful, process for the City to extricate itself from the CalPERS system. The system clearly is designed to discourage members from terminating their relationships with CalPERS. As the Mayor of Villa Park recently quipped, "[g]etting out of Calpers is like getting out of jail." Tim Reid, *California City Looks To Quit Calpers, Fears It Can't Afford To*, REUTERS (Aug. 27, 2014), *available at*

[149] City Br. at 22 ("any impairment of pensions would also unravel the City's current labor agreements"); *see* Union Br. at 4 ("The City cannot impair its employees' vested pension rights without rejecting its MOUs.").

[150] City Br. at 1 (emphasis in original).

[151] City Br. at 8; *see* SPOA Br. at 3.

[152] City Br. at 14; *see* SPOA Br. at 8; Union Br. at 8.

http://www.reuters.com/article/2014/08/27/usa-pensions-villapark-idUSL1N0QX25P20140827 ("Two other California cities, Pacific Grove and Canyon Lake, tried to quit Calpers last year, but both balked when they learned the termination fee.") [Comp. 440].[153]

It would be much easier for the City simply to treat Franklin fairly in this reorganization. If, however, the City persists in attempting to cram down a minuscule recovery on Franklin, the City must face up to the fact that it cannot have its cake (punitive treatment of Franklin) and eat it too (assumption of pension liability). If it wishes to cram down Franklin, it must pursue pension alternatives.

The City admits that alternatives do exist. They include a stand-alone City pension system, joining San Joaquin County's system, and contracting with a private pension administrator.[154] Mr. Lamoureux's testimony on this point was clear.[155] Strangely, however, the City does not admit to the most logical alternative – a defined contribution retirement plan. This is the desired alternative written into the PERL itself. CAL GOV'T CODE § 20485 ("It is the intent of the Legislature that contracting agencies in conjunction with recognized local employee organizations, develop alternative retirement plans that provide benefits under a defined contribution program."). And it is one that suffers from none of the "start up, transition and maintenance" costs bemoaned by the City.[156] Private 401(k) plan administrators abound and a competitive market exists for their services.

While conceding that there are alternatives, the City says that none of them are viable or "less costly." The City relies solely on Ms. Nicholl, its "pension expert," in this regard. The Court will recall that Ms. Nicholl was not even part of the City's case in chief. She was presented only as a "rebuttal expert" who limited her opinions to rebutting portions of "Opinion Three" in Mr. Moore's report[157] – that the City's "pension obligations, particularly for the safety plan, are very

[153] Much like the fabled Hotel California, "you can check in anytime you like, but you can never leave." Don Henley, Glenn Lewis Frey, Don Felder, *Hotel California*, *on* HOTEL CALIFORNIA (Asylum Records 1976).

[154] *See* City Br. at 7-14; *see* SPOA Br. at 3-6.

[155] Comp. 116-17 [5/14/14/ Tr. at 190:23-191:16 (Lamoureux)].

[156] City Br. at 10.

[157] Comp. 141 [6/4/14 Tr. at 40:11-23 (Nicholl)]; Comp. 281-85 [Trial Ex. 2642 at 48:18–49:2; 49:5-10; 49:14-19; 49:23–50:7; 50:9-13; 50:16-24; 51:1-6; 51:8-14; 52:11-19; 52:24-25].

high, growing and unpredictable." Mr. Moore's "Opinion Three" does not address potential alternatives to the CalPERS pension system, and Ms. Nicholl did not provide any affirmative expert testimony on the subject. Nevertheless, after hearing Mr. Lamoureux's devastating testimony about the lack of any incentive for City employees to seek employment elsewhere upon a plan termination (more on this below), the City scrambled Ms. Nicholl – taking advantage of the three-week trial break – to opine about alleged hurdles and problems the City might have in providing other sorts of retirement benefits.

However, because the City never actually investigated any alternatives, the hurdles and problems discussed by Ms. Nicholl are entirely hypothetical. She speculates about costs and delays the City would incur in establishing its own pension system, joining San Joaquin's system, or contracting with a third-party administrator, but the City has no facts to support that speculation. Critically, ***neither Ms. Nicholl nor the City suggest that the alleged additional costs and delays associated with a pension alternative come close to approaching – much less exceeding – the amount that the City would save by not assuming the burden of its prepetition pension liabilities***. In the Long-Range Financial Plan, the City projects that it will make more than $1.2 billion in payments to CalPERS over the next thirty years.[158] ***A huge proportion of those payments (70%) will go toward funding the currently unfunded portion of the City's prepetition pension obligations***. Ms. Nicholl admitted that the City could use those funds to establish an alternative retirement benefit program, and testified that she did not "have any basis" for assessing whether the benefits under an alternative program might be more lucrative than benefits under the CalPERS system.[159] Shockingly, neither she nor the City ever did the analysis.

Moreover, Ms. Nicholl could not identify a single additional cost or burden on the City associated with a defined contribution plan. She merely noted the obvious – that in a defined contribution plan, investment risk (and corresponding gain) rests with the individual beneficiary and

[158] Comp. 198-203 [LRFP at CTY257707-CTY257712, line 52].

[159] Comp. 145-46 [6/4/14 Tr. at 48:14-49:21 (Nicholl)].

is not spread across a pool as in the CalPERS system.[160] That is, of course, the entire purpose of a defined contribution plan, and it is something that the California Legislature expressly has endorsed. *See LaRue v. DeWolff, Boberg & Assocs.*, 552 U.S. 248, 250 n.1 (2008) ("a 'defined contribution plan' or 'individual account plan' promises the participant the value of an individual account at retirement, which is largely a function of the amounts contributed to that account and the investment performance of those contributions").[161]

b. *Employees Will Act Rationally Based Upon Their Future Compensation And Benefits*.

The City asserts that, without a CalPERS pension, employees will leave in droves.[162] The City supports that assertion with the speculative and somewhat self-serving testimony of Chief Jones and various current and former City employees. Because the City has never even hinted that it might seek to terminate its relationship with CalPERS, that testimony is completely hypothetical.

In contrast, Mr. Lamoureux's testimony was not hypothetical. He testified unequivocally that, upon termination of the City's relationship with CalPERS and a corresponding reduction in benefits, ***there is nothing that a City employee could do to eliminate or lessen the benefit reduction***, whether by changing employment or otherwise: "nothing they do going forward will change their benefits."[163] On cross-examination, Ms. Nicholl grudgingly agreed,[164] and the City

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[160] Comp. 139-40 [6/4/14 Tr. at 37:16-38:19 (Nicholl)]. The SPOA offers the same "criticism" of defined contribution plans. SPOA Br. at 6.

[161] The City complains that, if it were to leave the CalPERS system there would be an "intervening period" between CalPERS termination and establishment of a new retirement benefit program in which City employees "would be covered by Social Security," which the City denigrates (quoting Ms. Nicholl) as "not like a retirement benefit, realistically." City Br. at 6. This rather arrogantly dismisses a retirement program relied upon by the vast majority of Americans. It also assumes that there would be an "intervening period" when, in fact, the City could time its exit from bankruptcy to coincide with the establishment of a replacement retirement benefit, thereby avoiding any period in which City employees would participate in the Social Security system.

[162] City Br. at 14-19.

[163] Comp. 124 [5/14/14 Tr. at 204:17-18 (Lamoureux)]; *see* Comp. 125 [5/14/14 Tr. at 205:14-25 ("But let's say a decision was made that everyone's benefit has to be reduced by ten percent. Then even if someone left City of Stockton 15 or 20 years ago, that benefit would be subject to a reduction. . . . [A]nything that accrued up to the date they leave City of Stockton or the employer for which benefit[s] are reduced, those benefits would be reduced.") (Lamoureux)] and Comp. 126-27 [5/14/14 Tr. at 206:8-207:1 (Lamoureux)].

now concedes (for the first time) that "it is true that City employees would be unable to recover accrued benefits that had been cut."[165]

Yet the City insists that employees would flee nonetheless due to the "portable" or "reciprocal" nature of their CalPERS benefits. Specifically, the City argues that employees would leave the City – despite the fact that they could not resurrect any impaired pension benefits accrued to date – in order to be "grandfathered" into advantageous benefit tiers no longer available to new hires under the Public Employees' Pension Reform Act of 2013 ("PEPRA").[166] CalPERS' recent actions to gut PEPRA – condemned by Governor Brown two weeks ago – indicate that there may be little to no change in the PEPRA regime than under the prior rules. But even if CalPERS eventually has a change of heart and enforces PEPRA as the Legislature intended, the City's speculation misses the point and assumes that employees would not act rationally or in their best interests.

Specifically, given that there is nothing that can be done about benefits earned through the date of impairment, 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.[167] Even setting aside obvious barriers to employee relocation (such as the need to uproot home and leave family and friends), the fact is 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.

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[164] Comp. 147-48 [6/4/14 Tr. at 51:15-52:1 ("Q. If the City's current plan with CalPERS is impaired, there's nothing that a Stockton employee can do with respect to the impairment of benefits earned to the date of impairment; right? A. No. Although I suspect that if the . . . CalPERS contract were impaired, I would suspect that the employees would probably get together and sue someone over that. Q. Okay. Setting that aside, there's nothing they can do with respect to the impaired CalPERS benefit; right? A. Setting that aside, there's nothing they can do about it.") (Nicholl)].

[165] City Br. at 17.

[166] City Br. at 17-18.

[167] Comp. 148 [6/4/14 Tr. at 52:8-22 (Nicholl)].

Quite obviously, freeing up $1.2 billion in projected payments to CalPERS would pave the way for the City to offer highly-competitive benefits. The City does not explain, and cannot explain, how payment of prepetition debt in order to remain in the good graces of CalPERS is a more efficient and effective tool for retaining (much less recruiting) employees than the provision of enhanced compensation and benefits (including retirement benefits) directly to employees for service going forward.[168]

The City certainly has not met its burden of proof in that regard. In fact, the only non-speculative, non-hypothetical testimony on this point came from Mr. Moore, who described his personal experience with the City of Detroit. Specifically, Mr. Moore explained that, despite its efforts to impair and reduce prepetition pension liabilities, Detroit did not suffer employee flight. Rather, employees acted rationally with respect to future compensation and benefits:

> The City of Detroit made a decision that after years of not putting money towards services and investment because it had to devote so much towards pension and OPEB liabilities, that it needed to get those under control, and in order to put adequate funding towards services and investment that residents and businesses expect it needed to adjust those accrued benefits for both pension and OPEB.
>
> What I saw in that process, certainly I'm hearing a lot of here, based on comments yesterday, there was a strong belief that if anyone tried to touch accrued benefits, especially pension benefits, that all of the employees would leave. We have not seen that.
>
> As has been publicly reported, the city's plan does come up to the plate in adjustment to accrued pension benefits . . . , and we have not seen any impact from an employment standpoint.
>
> And the reason why is because I think that similar to a lot of situations when you are in distress, there's an emotional aspect; however, leaving is not going to change anything.

[168] This is the fatal flaw in the demonstrative (Trial Ex. 3085) used by Ms. Nicholl to illustrate alleged incentives for an employee to leave after CalPERS termination. Ms. Nicholl assumed that, following termination, employees who remained with the City would receive no pension and no retirement benefit whatsoever, with no corresponding increase in salary or other benefits. Specifically, "Stockton will lack resources to offer a substitute retirement plan if CalPERS is impaired." Comp. 144; 145 [6/4/14 Tr. at 47:14-18 (Nicholl); *id.* at 48:11-14 (analysis "doesn't include any pension, unknown pension or defined contribution plan that might be put into place if the CalPERS contract were impaired") (Nicholl)]. That is nonsensical. By terminating the CalPERS relationship, the City would not "lack resources" – it would have substantial additional resources to create an alternative retirement plan.

> And what we have done specifically with the City of Detroit, is we have made sure that we have a package that is going to attract employees going forward . . . .
>
> My experience, my firsthand experience with the situation that's going on right now, where this is happening has not resulted in what has been expressed.[169]

The bottom line is that alternatives exist. The City cannot use the bogeyman of employee flight to justify assumption of prepetition pensions in the face of a sub-1% cram down of Franklin.

IV. CALPERS' ALLEGED CLAIM FOR TERMINATION LIABILITY DOES NOT JUSTIFY ASSUMPTION OF PENSION LIABILITIES

Finally, the City and its organized labor groups argue that the City rationally chose to assume its pension liabilities because impairment would result in "a $1.6 billion termination liability that would swamp other claims."[170] The City and its union groups go so far as to query "how Franklin can contend that it would receive a greater payout by forcing the City to take on an additional $1.6 billion claim."[171] For its part, CalPERS claims a lien on all of the City's assets for the alleged termination liability, implying that it would be pointless for the City to discharge its pension obligations because CalPERS would suck up all resources that otherwise might be used to provide City services and pay creditor claims.[172]

Labor's argument is hypocritical. To recap: members of the labor groups are to receive full payment on their unsecured prepetition pension claims; Franklin is to receive less than 1% payment on its unsecured prepetition bond claim. The unions are in no position to hypothesize about the impact of termination on Franklin's recovery. It cannot get any worse for Franklin.

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[169] Comp. 104-05 [5/14/14 Tr. at 78:19-79:25 (Moore) (emphasis added)].

[170] City Br. at 3.

[171] City Br. at 7; Retiree Br. at 7 ("It's inconceivable that adding a $1.6 billion claim, even if unsecured, would improve distributions to any unsecured creditors."); SPOA Br. at 11 ("Termination liability that could be assessed under the PERL has been estimated at $1.6 billion, far larger than any other claim in the case."); Union Br. at 7 ("CalPERS would assert a claim for $1.5 billion-plus").

[172] CalPERS Plan Br. at 25-28.

Further, the City and its allies completely misapprehend the nature of the alleged claim for termination liability. Termination of the City's relationship with CalPERS would not result in a new liability; rather, termination simply would liquidate the City's existing liability for its dramatically underfunded pensions. It is nonsensical to suggest that the City somehow can avoid "swamping" unsecured claims by assuming (*i.e.*, agreeing to pay forever) the very liability that would be liquidated and reduced to an unsecured claim upon termination.

As shown below, the lien asserted by CalPERS is invalid and avoidable, the alleged claim for termination liability is inflated and, in whatever amount allowed, that claim would be a general unsecured claim that must be adjusted equitably with all of the City's other unsecured liabilities.

A. CalPERS Has No Lien.

Relying on section 20574 of the California Government Code, CalPERS argues that its alleged claim upon termination of the City's CalPERS contract would be secured by a senior lien on all of the City's assets.[173] Section 20574 provides in part as follows:

> A terminated agency shall be liable to the system for any deficit in funding for earned benefits, as determined pursuant to Section 20577, interest at the actuarial rate from the date of termination to the date the agency pays the system, and for reasonable and necessary costs of collection, including attorney's fees. The board shall have 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 [Comp. 371]. As the Court observed on July 8, there are several provisions of the Bankruptcy Code that render section 20574 invalid in a chapter 9 case.

1. Section 545 Invalidates The Termination Lien.

To start, any lien arising by operation of section 20574 is avoidable pursuant to section 545 of the Code, which provides in part that:

> The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien –
>
> (1) first becomes effective against the debtor –

[173] CalPERS Plan Br. at 25-28.

> (A) when a case under this title concerning the debtor is commenced;
>
> (B) when an insolvency proceeding other than 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; . . . [or]
>
> (2) 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.[174] The alleged lien in favor of CalPERS is a "statutory lien" within the meaning of section 545. 11 U.S.C. § 101(53) ("The term 'statutory lien' means lien arising solely by force of a statute on specified circumstances or conditions . . . ."). It is independently avoidable under both subsection 545(1) and 545(2).

a. *The Lien Is Avoidable Under Subsection 545(1).*

Section 545(1) invalidates liens that arise upon a debtor's insolvency or financial distress. "Congress has perceived such liens to be thinly disguised attempts to impose state-determined priorities in bankruptcy." *In re Loretto Winery Ltd.*, 898 F.2d 715, 718 (9th Cir. 1990); *see, e.g.*, *In re Davis*, 22 B.R. 523, 525 (Bankr. W.D. Pa. 1981) ("The history of [the predecessor to section 545] shows that the act was intended to prevent state laws which prioritized liens on the happening of insolvency from undercutting federal bankruptcy laws."); S. Rep. 89-1159, at 2 (1966) ("These spurious liens were in reality disguised priorities and the effect of their recognition in bankruptcy would be to distort the federally ordered scheme of distribution . . . .") [Comp. 434].

Section 20574 is precisely that – an attempt to impose state-determined priorities in bankruptcy through a "spurious lien." CalPERS basically admits this. It states that "one of the primary purposes of the statute is to ensure that the System [CalPERS] is protected in the event of the bankruptcy of a contracting agency."[175] Previously in this case, CalPERS was even more direct:

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[174] Section 545 applies in chapter 9. 11 U.S.C. § 901(a); *In re Badger Mountain Irr. Dist.*, 885 F.2d 606, 608 n.1 (9th Cir. 1989); *County of Orange*, 191 B.R. at 1018. Should the City refuse to seek avoidance of the purported CalPERS termination lien, the Court would be empowered to appoint a trustee to do so. 11 U.S.C. § 926(a).

[175] CalPERS Br. at 26.

> Based on the legislative history, the intent of this section (adopted in 1982) was to elevate CalPERS' rights from that of a general unsecured creditor to that of a senior secured creditor as a matter of law. The legislative history contains discussion of the intent to "grant PERS a lien against the assets of public agencies who have terminated their membership in the system, usually as a result of agency dissolution and bankruptcy who have unfunded liabilities owed to PERS for vested employee benefits and have no ability to pay such liabilities." The legislative history goes on to indicate that under then existing law, CalPERS was only an unsecured creditor.[176]

In fact, CalPERS was the sponsor of the bill that led to the enactment of section 20574,[177] shortly after Congress amended the Bankruptcy Code in 1978 to broaden chapter 9 to provide for rejection of collective bargaining agreements and adjustment of resulting claims and other employee obligations.[178] The legislative record of that bill unequivocally evinces an intent to elevate and prioritize alleged claims of CalPERS in the event a terminating agency's financial condition renders it unable to satisfy those claims in bankruptcy or otherwise:

> In the event an agency is unable to provide for the payment of the vested retirement liabilities of its employees, PERS is in the position, essentially, of an unsecured creditor. Current retirement law does not provide any priority for retirement obligations. If we are unable to secure adequate financing, member retirement benefits must be proportionately reduced, both for current and future employees. This bill would follow traditional wisdom that retirement contributions are, in reality, deferred compensation, by establishing a lien against agency assets second only to wages. The purpose is to secure the employees' retirement rights before the assets of the bankrupt agency are distributed to holders of other liens.[179]

As explained below, there is no lien under section 20574 until a CalPERS member becomes a "terminated agency" and CalPERS calculates a "deficit in funding for earned benefits . . . pursuant to [s]ection 20577" of the Government Code. Because the required calculation of the "actuarially

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[176] CalPERS Elig. at 15 n.12 (quoting legislative history of section 20574) (emphasis added).

[177] Comp. 395, 396, 397, 399 [excerpts from legislative history of section 20574, as compiled by Legislative Research & Intent LLC ("Leg. Hist. 20574"), at 24, 33, 37, 45].

[178] *See, e.g.*, H.R. Rep. 94-686, at 8 (1976) ("The bill grants the court two powers which a bankruptcy court has under Chapters X and XI, and under section 77, but which had not previously been granted under Chapter IX. The first is the power to permit the petitioner to reject executory contracts.") (referencing rejection of collective bargaining agreements) [Comp. 438]. CalPERS ignores the obvious correlation between the enactment of amended chapter 9 and the subsequent passage of section 20574, blithely asserting that the Court was wrong to connect the dots in this regard. CalPERS Br. at 27 n.20.

[179] Comp. 400; 398, 401, 402, 403, 404, 405 [Leg. Hist. 20574 at 72 (emphasis added); *see, e.g.*, *id.* at 43, 105, 125, 128, 131, 136 (same)].

determined deficit in funding" under section 20577 cannot occur until "the date of termination," CAL. GOV'T CODE § 20577 [Comp. 375], the lien by definition arises only upon the terminated agency's financial distress and inability to pay its alleged termination liabilities.

As a consequence, the lien "first becomes effective against the debtor . . . when the debtor becomes insolvent [or] when the debtor's financial condition fails to meet a specified standard" and it therefore is avoidable pursuant to section 545(1).

b. *The Lien Is Avoidable Under Subsection 545(2).*

Independently, the alleged CalPERS lien also is avoidable under subsection 545(2) because it was unenforceable against a bona fide purchaser on the date the City filed its chapter 9 petition.

In fact, the text of section 20574 makes clear that CalPERS had no lien whatsoever on the petition date because, at that time, the City had not terminated its relationship with CalPERS. Section 20574 provides only for CalPERS to "have a lien on the assets of a terminated contracting agency." CAL. GOV'T CODE § 20574 (emphasis added). At the time of bankruptcy (and to this date), the City was current in its obligations to CalPERS and had not attempted to terminate the CalPERS contract. Accordingly, the City was not a "terminated contracting agency" and section 20574 did not apply to it.

Further, section 20574 provides for a lien only "in an amount equal to the actuarially determined deficit in funding for earned benefits," which is "determined pursuant to Section 20577" of the Government Code. *Id.* Section 20577 provides for the terminated agency to pay an amount equal to the difference between accumulated contributions and "the actuarial equivalent specified in clause (1) of subdivision (a) of Section 20576." *Id.* § 20577. The "actuarial equivalent" specified in section 20576(a)(1) is a calculation of "the amount th[e] system is obligated to pay after the effective date of termination." *Id.* § 20576(a) (emphasis added) [Comp. 373]. In other words, there can be no calculation, and hence no lien, under section 20574 until "the effective of termination." This is made clear by the fact that section 20577 provides for interest on the claim to run "from the date of contract termination" and not earlier. *Id.* § 20577.

Mr. Lamoureux testified to this point. He stated that the effective date of termination "is really the only time where the unfunded liability would become owing and due . . . . When a member terminates their contract, the unfunded liability is due at that time."[180] CalPERS admits as much in its brief, conceding that it does not perform a final calculation of termination liability until "the effective date of termination occurs."[181] Indeed, on several prior occasions CalPERS asserted that it would have no claim whatsoever unless the City sought to terminate the CalPERS contract. According to CalPERS: "So long as the City continues to participate in the system, it does not owe CalPERS unfunded liability amounts or termination obligations in the millions or billions of dollars. . . . The City is in good standing with CalPERS and is current on its payments to the system. Accordingly, there is no debt to CalPERS that will be adjusted in the City's plan."[182] While this reveals CalPERS' ignorance of the Bankruptcy Code's broad definition of "claim," which includes unliquidated, contingent and unmatured obligations,[183] it also shows that there was no liquidated amount of termination liability as of the petition date, meaning that there could not possibly have been a lien under section 20574 at that time.

Under California law, "[n]o lien arises by mere operation of law until the time at which the act to be secured thereby ought to be performed." CAL. CIV. CODE § 2882 [Comp. 355]. Because the City had no obligation to make a payment for alleged termination liability as of the petition date, no lien existed in favor of CalPERS at that time. CalPERS' new assertion to the contrary – that "CalPERS has a lien on the assets of a municipality as soon as the municipality joins CalPERS" –

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[180] Comp. 112 [5/14/14 Tr. at 178:2-5 (Lamoureux)].

[181] CalPERS Plan Br. at 21 ("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. Once the effective date of the termination occurs, CalPERS completes a final calculation based on final data.") (citing Lamoureux trial testimony).

[182] CalPERS Elig. at 2-3; *see, e.g.*, CalPERS Conf. at 7 n.1 ("Because the City has timely fulfilled its contribution obligations under the CalPERS Pension Plan, CalPERS does not concede that it would have any 'Pre-Confirmation Date Claims' purportedly subjecting it to the injunction. The Bankruptcy Code definition of 'claim' may not apply to any part of a theoretical future Termination Payment associated with pre-Confirmation Date Services."); *CalPERS' Summary Of Supplemental Limited Objections Regarding The City Of Stockton's First Amended Plan Of Adjustment* [D.I. 1362] at 6 n.1 (same).

[183] 11 U.S.C. § 101(5).

conflicts with the text of the statute, with the basic principles established by the California Civil Code, and with CalPERS' own pronouncements in this case. It simply is not credible.[184]

In any event, under governing California law,[185] a bona fide purchaser of assets from the City on the petition date would have had rights superior to CalPERS' alleged lien. *Islander Yachts, Inc. v. One Freeport 36-Foot Vessel, No. 145*, 173 Cal. App. 3d 1081 (1985), demonstrates this point. There, a sailboat manufacturer built a vessel for a dealer. The manufacturer had a statutory lien on the vessel with "preference over all other demands" under section 491 of the California Harbors and Navigation Code.[186] The dealer sold the vessel to a bona fide purchaser without paying the manufacturer, and the manufacturer claimed that its statutory lien remained on the vessel. The court held that the bona fide purchaser had rights superior to those of the manufacturer, concluding that "there is nothing about the statutory lien . . . which protects it from defeasance upon transfer of the property to a bona fide purchaser for a value without notice." *Islander Yachts*, 173 Cal. App. 3d at 1089 (quoting trial court); *see, e.g.*, *Graham v. Annis*, 28 Cal. App. 754, 760 (1915) (same); *see also* CAL. COM. CODE § 2403(1) ("A person with voidable title has power to transfer a good title to a good faith purchaser for value.").

In other words, the rights of the bona fide purchaser prevailed over the rights of the statutory lien holder. Applying the same reasoning, a hypothetical bona fide purchaser from the City on the petition date would have rights superior to CalPERS' alleged rights. Any lien that CalPERS otherwise might possess by virtue of section 20574 of the Government Code therefore is avoidable under section 545(2) of the Bankruptcy Code.

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[184] The City asserts that outside of bankruptcy "the CalPERS Lien would . . . trump Franklin's own security." City Br. at 27. The City provides no support for that astonishing claim. Given that Franklin's lien arose years before any CalPERS lien might arise, Franklin has vested property rights in the collateral as to which CalPERS would possess a junior lien, at best.

[185] "[A] statutory lien's validity against a bona fide purchaser is determined under state law." *Loretto Winery*, 898 F.2d at 720.

[186] "All vessels are liable for: . . . (c) Work done or materials furnished in this State for their construction, repair, or equipment. . . . Demands for these several causes constitute liens upon all vessels, have priority in the order enumerated, and have preference over all other demands; but such liens only continue in force for the period of one year from the time the cause of action accrued." CAL. HARB. & NAV. CODE § 491.

Consequently, CalPERS' efforts to establish priority over Franklin fails, and the alleged termination lien cannot be a basis for the City's decision to assume its prepetition pension liabilities.

2. Section 362 Prohibits Creation And Enforcement Of The Termination Lien.

Independently, regardless of whether or not the termination lien is avoidable, section 362 of the Bankruptcy Code prohibits the alleged lien from attaching to any assets of the City. Specifically, section 362(a)(4) stays "any act to create, perfect, or enforce any lien against property" of the City. 11 U.S.C. § 362(a)(4). Because CalPERS had no lien as of the petition date, it is now stayed from enforcing any of its alleged lien rights. *See, e.g.*, *In re CSC Indus., Inc.*, 232 F.3d 505, 510 (6th Cir. 2000) (section 362(a)(4) prohibits the postpetition attachment of the PBGC's statutory lien for a debtor's unfunded prepetition pension obligations); *In re CF&I Fabricators, Inc.*, 179 B.R. 704, 708 (D. Utah 1994) (same); *In re Kent Plastics Corp.*, 183 B.R. 841, 845 (Bankr. S.D. Ind. 1995) (same); *In re Chateaugay Corp.*, 130 B.R. 690, 697 (S.D.N.Y. 1991), *vacated due to settlement*, 1993 U.S. Dist. LEXIS 21409 (S.D.N.Y. June 16, 1993) (same).

Thus, if the City were to terminate its relationship with CalPERS during the bankruptcy case, CalPERS would have no ability to assert or enforce the alleged statutory lien. Then, after confirmation of a plan providing for impairment of pension obligations, the City would be protected by the discharge injunction. 11 U.S.C. § 944. Here again, the alleged termination lien cannot be a basis for the City's decision to assume its prepetition pension liabilities.

B. CalPERS' Alleged Claim For Termination Liability Is Inflated.

It also is evident that CalPERS' claim for termination liability would not approach the $1.6 billion claimed by the City and its allies.

The $1.6 billion calculation is set forth in the CalPERS 2012 Annual Valuation Report for the City's Safety Plan and Miscellaneous Plan. In those reports, CalPERS calculated the City's "hypothetical termination liability" as if the City "had terminated [its] contract with CalPERS as of June 30, 2012."[187] Specifically, CalPERS determined that the assets in the City's Safety Plan as of June 30, 2012, had a market value of approximately $571.6 million while the City's "hypothetical

[187] Comp. 288 [Safety Plan Rep. at 28]; Comp. 291 [Misc. Plan Rep. at 28].

termination liability" – *i.e.*, the estimated liability of all benefits vested as of that date – was approximately $1.61 billion, leaving an alleged "unfunded termination liability" of approximately $1.04 billion.[188] For the Miscellaneous Plan, CalPERS determined that the market value of plan assets as of June 30, 2012, was approximately $431.2 million while the City's hypothetical termination liability was approximately $1.01 billion, leaving an alleged unfunded termination liability of approximately $575.9 million.[189] Thus, CalPERS calculated the City's total hypothetical termination liability to be approximately $1.62 billion ($1.04 billion + $575.9 million).

One problem is that those calculations were made with data as of June 30, 2012. Since that time, the market value of assets under CalPERS management has soared. The value of CalPERS investments grew by 12.5% in fiscal year 2012-13 (ending June 30, 2013) and by another 18.4% in fiscal year 2013-14 (ending June 30, 2014).[190] This obviously has the effect of increasing the market value of assets in the City's Safety and Miscellaneous Plans and thereby reducing the alleged hypothetical termination liability. Moreover, since June 30, 2012, the discount rate used to calculate the hypothetical termination liability – the yield on 30-year US Treasury Separate Trading of Registered Interest and Principal of Securities (STRIPS) – has increased materially, from 2.98% on June 30, 2012, to 3.25% as of August 29, 2014.[191] This also has the effect of decreasing the amount of the hypothetical liability, again reducing any claim that might arise upon the City's termination of its CalPERS relationship.

Further, as Mr. Lamoureux testified, CalPERS has "determined that, because of the 2008/2009 losses, employers should retire the unfunded liability on a more accelerated basis. This policy decision has the effect of front loading the payments necessary to fund benefits such that contributions will increase and be higher than under the previously approved amortization

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[188] Comp. 288 [Safety Plan Rep. at 28].

[189] Comp. 291 [Misc. Plan Rep. at 28].

[190] RFJN, Ex. E. In comparison, the S&P 500 has returned 47.1% since June 29, 2012. RFJN, Ex. F. At least for the last several years, beneficiaries would have been better off with a 401(k) (a defined benefit plan) invested in an S&P index fund.

[191] RFJN, Ex. G.

policies."[192] Under this revised policy, because the City has continued to pay its CalPERS contributions during the bankruptcy case, the size of the City's unfunded pension liability has decreased since June 30, 2012. As a consequence, the City's current alleged termination liability is substantially smaller than the hypothetical liability calculated by CalPERS as of a date that is now more than two years in the past.

More fundamentally, CalPERS' calculation of termination liability materially overstates the City's actual liability in respect of vested pension obligations. Per Mr. Lamoureux, the CalPERS calculation is deliberatively "conservative."[193] It is designed to ensure that CalPERS has no conceivable risk of underfunding upon a contracting member's termination.[194] In fact, CalPERS recently changed the calculation methodology in order to maximize the amount of a terminated member's liability. In a directive to its members, CalPERS specifically noted that, "[d]ue to the current economic environment and budget issues faced by public agencies, there is increasing pressure on public agencies to amend or terminate pension plan contracts," and it explained that "this new termination calculation method will increase the amount of assets that employers will need to leave behind when they terminate; if there is insufficient assets in the employer's account at CalPERS, the employer will be required to make up the shortfall."[195]

The dramatic impact of CalPERS' change in methodology – specifically designed to burden the most vulnerable of its members (those with "budget issues") – can be seen from the 2012 Valuation Reports referenced above. The Safety Plan Report, for example, reveals that the methodology change caused the City's hypothetical termination payment to increase by nearly $454 million from June 30, 2011 (using the prior calculation methodology) to June 30, 2012 (using the modified calculation methodology).[196] Similarly, the change in methodology for the

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[192] Comp. 345-46 [Lamoureux DTD ¶ 36]; Comp. 121-23 [5/14/14 Tr. at 198:16-200:22] (Lamoureux)].

[193] Comp. 347 [Lamoureux DTD ¶ 39]; Comp. 113-14 [5/14/14 Tr. at 179:17-180:8 (Lamoureux)].

[194] Comp. 347-48 [Lamoureux DTD ¶¶ 39-40]; Comp. 112-14 [5/14/14 Tr. at 178:6-180:8 (Lamoureux)].

[195] Comp. 351 and 353 [Lamoureux DTD, Ex. 11 at 1 and 3 (emphasis removed)].

[196] Comp. 288 [Safety Plan Rep. at 28].

Miscellaneous Plan caused the City's hypothetical termination payment to increase by an additional $218 million.[197] ***The mere stroke of CalPERS' pen produced a $672 million increase in the alleged termination liability***.

This case starkly illustrates the skewed nature of CalPERS' methodology in calculating a member's termination liability. As noted above, the Long-Range Financial Plan projects that the City's total payments to CalPERS over the next thirty years will approximate ***$1.2 billion***. This includes both payments to fund the unfunded portion of the City's prepetition pensions and payments to fund the "normal cost" of pension benefits earned over that period. In contrast, CalPERS calculates the City's termination liability as of the petition date – which represents only the City's unfunded prepetition liability – at more than ***$1.6 billion***. The difference between $1.2 billion paid over thirty years and an immediate $1.6 billion liability is enormous. Clearly the CalPERS termination claim is inflated and not reflective of the City's actual prepetition liability.

The CalPERS methodology thus does not produce an accurate, realistic estimate of the City's actual petition date liability for unfunded pensions. As a result, that methodology is not appropriate for use in determining the amount of the claim that would be allowed upon termination of the City's CalPERS contract. Rather, in the event of termination by the City, the Court would estimate the City's actual liability using standard methods frequently employed in the estimation of unliquidated claims under section 502(c) of the Bankruptcy Code. *See, e.g.*, *In re SNTL Corp.*, 571 F.3d 826, 838 n.13 (9th Cir. 2009); *In re Falk*, BAP No. NC-12-1385-DJuPa, 2013 Bankr. LEXIS 4645, at *17 (BAP 9th Cir. Sept. 26, 2013) ("'Estimation' for the purposes of section 502(c)(1) simply means that the bankruptcy court may exercise its discretionary powers to determine the allowability of claims in bankruptcy in accordance with the principles of equity.") (quoting *In re Ford*, 967 F.2d 1047, 1049 n.3 (5th Cir. 1992)).

Those methods – grounded in equity – are sure to produce a dramatically-smaller claim in the event of the City's termination of its relationship with CalPERS.

[197] Comp. 291 [Misc. Plan Rep. at 28].

C. CalPERS' Claim For Termination Liability Must Be Adjusted Equitably With The City's Other Unsecured Liabilities.

In any event, whatever the amount of the claim upon termination, the Bankruptcy Code requires that the City adjust that debt fairly and equitably with the City's other debts. The mere size of the claim – no matter how large – provides no justification for the City to assume the liability.

Indeed, the larger the claim, the more the Bankruptcy Code mandates an adjustment, lest a municipal debtor leave unadjusted so much debt that the plan becomes infeasible and likely to be followed by the need for further financial reorganization of the debtor. *See, e.g.*, *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 34-35 (Bankr. D. Colo. 1999) ("Since insolvency is the foundation of Chapter 9 eligibility, it would make little sense to confirm a reorganization plan which does not remedy the problem.").

Bankruptcy is about fair, equitable and nondiscriminatory debt adjustment. It is not about wholesale debt assumption and discrimination. Assumption of a billion dollar liability for unfunded prepetition pensions does nothing to justify the City's punitive 1% treatment of Franklin's much smaller claim.

V. CONCLUSION

However calculated, the City's liability for unfunded prepetition pensions is massive, potentially $1 billion or more. That debt, which is a remnant of irresponsible decisions of the City's not-so-distant past, is subject to adjustment in this case. In fact, this case is the City's only realistic opportunity to reduce its crushing pension liability. If the City does not act now, it will squander its one-time opportunity and continue paying for the sins of its past for decades to come.

The Bankruptcy Code requires the City to adjust all of its debts fairly, equitably, and without unfair discrimination. There is nothing about pension liability that immunizes it from adjustment, and there is no "business judgment" rule that exempts pensions from the strictures of the Code. Nothing supports the City's preordained decision to immunize pensions in any event. The City has plenty of alternatives. It simply does not want to explore them.

Given this, the Plan cannot be confirmed. Franklin requests that the Court deny confirmation and send the City back to the drawing board, where it will have a choice. The City either must treat Franklin fairly, paying Franklin's claim from the ample revenues that will become available over time, or it must attempt to impose on all of its creditors the same draconian (and unjustified) impairment that the City has reserved for Franklin to date. The City cannot wipe out Franklin's claim through a 1% cram down without also taking advantage of its ability to discharge its prepetition pension liability and other debts.

Dated: September 3, 2014

JONES DAY

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