



SUMMARY OF CalPERS LEGAL POSITION IN MUNICIPAL BANKRUPTCIES

As Delivered by Peter Mixon to the CalPERS Board of Administration on September 12, 2012

Several public agencies that provide retirement benefits through CalPERS have recently filed for bankruptcy under Chapter 9 of the Bankruptcy Code. CalPERS is a creditor of these agencies and of course has an interest in the outcome of these bankruptcy proceedings. I am here this morning to give a high-level summary of the legal position that CalPERS will be taking in these actions.

1. CalPERS is, of course, an arm of the State of California. California, like every other State in the Union, has sovereign powers. And, under our system of government, the United States Constitution created a system of dual sovereignty which divides powers between the federal government and the States. The Supreme Court recently explained: “[t]he Framers concluded that allocation of powers between the National Government and the States enhances freedom, first by protecting the integrity of the governments themselves, and second by protecting the people, from whom all governmental powers are derived.” *Bond v. United States*, 131 S.Ct. 2355, 2364 (2011).

2. Thus, when State sovereignty is subject to displacement by federal law, Congress’s intent must be “clear and manifest.” It is for this reason that the United States Supreme Court has held on several occasions that certain State laws, which may inhibit the power of a bankruptcy court, are not preempted by the Supremacy Clause.

- a. Why Is This Important?
- b. Preemption – means that federal law takes precedence over state laws
- c. Important – If preemption applies, bankruptcy court could take action that would otherwise be illegal under State laws

3. The drafters of the Bankruptcy Code acknowledged that certain powers have been reserved to the States under the United States Constitution and therefore limit the power of the Bankruptcy Court to interfere with the State’s control over municipalities and State agencies in a bankruptcy case.

4. For example, section 903 of the Bankruptcy Code expressly sets limits on the power of the Bankruptcy Court. It is not a “gatekeeping” provision, which allows a bankruptcy court to abrogate all aspects of State Sovereignty once a municipality files a bankruptcy petition. Instead, this statute means what it says: before, during, and after bankruptcy, the law of the State controls a municipality in the exercise of its governmental and political powers.

5. In enacting section 903 of the Bankruptcy Code, Congress further determined that Chapter 9 of the Bankruptcy Code would not preempt state laws that control the political and governmental powers of municipalities and arms of the State. In this respect, Chapter 9 is different from all other chapters of the Bankruptcy Code. Congress acted wisely to avoid a constitutional clash by preserving the authority of States over their core aspects of sovereignty in any municipal bankruptcy case.

6. The limitations on the power of the bankruptcy courts extend to the relationship between CalPERS and a participating public agency employer. The relationship between CalPERS and a municipal employer is not a mere commercial contract between a creditor and a debtor. Instead, it is an aspect of the State's control over a municipality that is protected from interference under constitutional principles and federal bankruptcy law. Accordingly, Chapter 9 of the Bankruptcy Code does not preempt the State of California's control over the system of benefits provided to its employees and the employees of participating municipalities such as the City of Stockton.

7. The Legislature created CalPERS eighty years ago to "effect economy and efficiency in the public service" by providing a pension plan to pay retirement compensation and death benefits to public employees and their families. Under State law, a municipality may choose to provide retirement benefits through the CalPERS system. An agreement between a municipality and CalPERS reflects the choice of the municipality to participate in the system. Once a municipality commences its relationship with CalPERS, the municipality is bound by the constitutional and statutory provisions governing the system and the decisions of the CalPERS Board of Administration.

8. As created by the Legislature and confirmed by the People, the CalPERS pension plan is a trust fund, which consists of the assets that are needed to pay retirement and other benefits that participating public employers have promised to their employees. The California Constitution and state statutes define this trust relationship and the rights and duties of the Board of Administration, the public employers and the members of the system.

9. As trustee of the retirement system, CalPERS is a fiduciary and must ensure the integrity of the State of California's benefits system. CalPERS does not have the right to "forgive" or reduce employer contributions which are necessary to sustain the soundness of the system and ensure the payment of promised benefits.

10. Pursuant to California law, a public agency must follow the governing statutes when it chooses to participate in the retirement system. These statutes preclude an agency from lowering the benefit formula for existing employees who are members of the system. CalPERS does not have the right to approve a lower benefit formula for these members.

11. Under the law of the State of California, a participating public employer in bankruptcy may not terminate its relationship with CalPERS through “rejection” of its “contract” with CalPERS in the bankruptcy proceeding.

12. Participating public agency employers do have the right, under California law, to terminate their relationship with CalPERS. However, termination of this relationship does not terminate the obligations of the public agency to make contributions to CalPERS to fund benefits accrued prior to termination. Instead, California law provides for a valuation of the assets and liabilities of the employer at the time of termination. Because termination of the relationship essentially closes the pension plan, any unfunded liabilities as of termination must be fully paid by the employer. These amounts are typically much larger than the ongoing obligations owed by the employer prior to termination. Termination by a municipal debtor would create a much larger obligation to CalPERS, which would impair the ability of the debtor to make payments to its unsecured creditors and severely dilute the return to such creditors.

13. When a participating public agency terminates its relationship with CalPERS, CalPERS is entitled to priority over unsecured creditors under the laws of the State of California. An example of a statute that affords CalPERS a priority is California Government Code Section 20574. This statute provides that CalPERS has a lien on all assets of a municipality to secure all liabilities of the municipality to CalPERS owing upon a termination of the relationship, including any deficit in funding for earned benefits, interest, and attorneys' fees and other collection costs. As secured creditors are paid before unsecured creditors, this lien creates a priority in favor of CalPERS.

14. Bond insurers and other sophisticated Wall Street financial players have suggested that it is unfair to protect the pension benefits promised to municipal employees and their families. Of course, the bond insurers are presumably experts in evaluating the financial condition of municipalities and were presumably paid large fees to assume the risk of nonpayment of certain municipal debts. Indeed, one of these insurers touts its financial acumen as follows: “National only guarantees transactions that meet our strict risk management guidelines and portfolio limits. In each and every one of our transactions, multiple considerations and possible outcomes are analyzed before recommendations are made. Ours is a careful, vigilant approach backed by solid financials and an unparalleled performance record.” To protect their profits, these insurers are now demanding that municipalities renege on commitments made to thousands of present and former employees to honor earned pension benefits. CalPERS members – policemen, firefighters, and other public employees who have labored to serve the public benefit for years – have rights which make it fair that their pension benefits are fully honored in the bankruptcy process.

Thank you Mr. President and members of the Board. This concludes my presentation.

-Peter Mixon, CalPERS General Counsel