

STOCKTON BANKRUPTCY RULING

Chief Judge Christopher Klein of the U.S. Bankruptcy Court for the Eastern District of California ruled on Wednesday during Stockton, CA's bankruptcy hearing that the City could reject its contract with CalPERS, the prominent state pension fund, as part of its restructuring. Stockton's current bankruptcy plan does not include cuts to pensions, and the Chief Judge Klein made it clear he is not advocating that the city should or should not cut pensions. However, the ruling does have broader implications, specifically for California, and possibly nationwide. California state law provides CalPERS seniority in a debt restructuring, but the Court ruled that when a city enters Chapter 9 federal bankruptcy, the Supremacy Clause in the U.S. Constitution kicks in, and federal law supersedes any state protections. Judge Klein's ruling is similar to Judge Rhodes' ruling in December 2013 as part of Detroit's bankruptcy, in which the Court stated that federal bankruptcy law trumps Michigan's constitutional protections.

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WHAT THIS MEANS FOR THE MUNICIPAL MARKET

- Despite the comments from the two Courts, pension protections have yet to actually be challenged in a court with a defined ruling. Detroit settled out-of-court with pensioners, and San Bernardino has negotiated a settlement with CalPERS, although those details have not been released.
- As we speculated in December 2013 following the Detroit ruling, allowing pension benefits to be cut may actually decrease bankruptcy filings. Pension funds may be more willing to negotiate pre-bankruptcy where they have more flexibility. Relying on a court ruling may result in lower recoveries.
- Stockton is two years into their bankruptcy. Bankruptcy remains a timely and costly endeavor that will continue to be a last resort. In addition, a number of eligibility requirements must be met to enter bankruptcy protection.
- Ultimately, we believe that the constitutional relevance of protecting pension benefits will require a review and judgment by the U.S. Supreme Court. The timetable for that is uncertain and will not occur until pension benefits are actually challenged in court.

This last point is pure speculation, but something that we feel should be considered:

- The states are provided the power to determine whether their underlying municipalities may file for Chapter 9 protection. Under the Tenth Amendment of the U.S. Constitution, each state holds sovereign powers to determine the necessary steps a municipality must undertake prior to filing for bankruptcy. If there is a political push to protect pensions and employee benefits, states may actually tighten up bankruptcy eligibility requirements. If states make it difficult for a municipality to seek bankruptcy protection, then restructurings would take place out of federal courts where state laws and protections could play a bigger role.

For further information regarding the case, please visit the website for the U.S. Bankruptcy Court, Eastern District of California at:

<http://www.caeb.uscourts.gov/Stockton/Default.aspx>.

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