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 13 Retirement System

14 UNITED STATES BANKRUPTCY COURT
 15 EASTERN DISTRICT OF CALIFORNIA
 16 SACRAMENTO DIVISION

17 In re
 18 CITY OF STOCKTON, CALIFORNIA,
 19 Debtor.

20 Case No. 2012-32118

21 D.C. No. OHS-1

22 Chapter 9

23 **CALPERS' BRIEF IN SUPPORT OF THE**
 24 **CITY OF STOCKTON'S PETITION**

25 Date: February 26, 2013

26 Time: 1:30 p.m.

27 Place: Robert T. Matsui U.S. Courthouse,
 28 501 I Street
 Department C, Fl. 6, Courtroom 35
 Sacramento, CA 95814

Judge: Hon. Christopher M. Klein

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1 The California Public Employees' Retirement System ("CalPERS") files this brief in support
2 of the request of the City of Stockton (the "City" or "Stockton") that this Court determine it to be
3 eligible for chapter 9 protection. This Court should (1) overrule the objections of the Capital Markets
4 Creditors;¹ (2) determine that Stockton is eligible for protection under chapter 9; and (3) enter an
5 order for relief. In addition to what the City argues, as explained below, the objections of the Capital
6 Markets Creditors should be overruled because the City did not act in bad faith in making the
7 legitimate business decision to continue to offer benefits to its employees and retirees through
8 CalPERS.

9 **I. PRELIMINARY STATEMENT**

10 The Capital Markets Creditors have forced the City of Stockton and other parties in interest to
11 spend millions of dollars and more than seven months litigating the City's eligibility for bankruptcy
12 protection.² The Capital Markets Creditors' public relations efforts and their litigiousness are an
13 effort to bully the City into abandoning its provision of retirement benefits to its employees and
14 retirees through the CalPERS system. That this strategy is not really about eligibility is apparent in
15 the statements made by the Capital Markets Creditors' counsel in Court just a few weeks ago "Lord
16 help us," one counsel proclaimed, if this case gets dismissed and it has to be re-filed. Another stated
17 that dismissal of this case "is in no one's interest." *See* Declaration of Michael B. Lubic ("Lubic
18 Dec."), Exhibit 1 at 89, 75 (relevant portions of Transcript of Hearing Held January 30, 2013
19 Regarding Rule 9019 ("9019 Hearing")). On this score, the Capital Markets Creditors are absolutely
20 correct: It is in no one's interest to continue to delay the City's access to the Bankruptcy Court for
21 the purpose of proposing a plan of adjustment of its debts. Entry of an order of relief will allow the
22 City to move forward with its necessary financial restructuring.

23
24 ¹ The term "Capital Markets Creditors" refers to the following entities: (1) Assured Guaranty Corp.
25 and Assured Guaranty Municipal Corp. (collectively "Assured"); (2) National Public Finance
26 Guarantee Corporation ("National"); (3) Franklin High Yield Tax Free Income Fund and Franklin
27 Corporation High Yield Municipal Fund ("Franklin"); and (4) Wells Fargo Bank, National
28 Association, in its capacity as an indenture trustee.

² CalPERS has itself spent hundreds of thousands of dollars responding to discovery requests of the
Capital Markets Creditors and their eligibility litigation campaign.

1 The Capital Markets Creditors fundamental argument in opposition to the City’s eligibility is
2 that, as a matter of law, the City was required to “negotiate” with CalPERS for a modification of the
3 debts that are owed to it in order to be eligible for bankruptcy relief. On this point, the Capital
4 Markets Creditors are wrong. The Capital Markets Creditors misconstrue (perhaps intentionally) the
5 nature of the relationship between CalPERS and the City to support a tortured argument that the
6 City’s relationship to CalPERS is the same as the City’s relationship to its bondholders and bond
7 insurers. CalPERS’ relationship with the City is not remotely similar—CalPERS is an arm of the
8 State of California which administers the State’s public pension system. CalPERS acts as a trustee
9 for the public employment retirement system and has fiduciary obligations to maintain the integrity
10 of that system for benefit of its members and for the ultimate benefit of the citizens of the State of
11 California.

12 The City is a participant in the public employment retirement system with legal obligations to
13 comply with the State’s laws in connection with the provision of benefits to CalPERS’ members.
14 The relationship between CalPERS and the City is executory in nature: CalPERS continues to
15 provide benefits and the City continues to report, fund and otherwise comply with State law in
16 connection with its participation in the system. The City’s obligations to CalPERS are not
17 negotiable. A well developed, substantial body of State law governs the obligations of the City to
18 CalPERS. It is nonsensical to suggest that the City could or should negotiate with CalPERS
19 regarding its ongoing legal obligations relating to provision of benefits through the system. CalPERS
20 submits below an explanation of its role in providing benefits to the public employees of the State of
21 California and other public agencies, as well as its relationships with employers like the City, to
22 better inform the Court regarding the nature of the legal relationship between the City and CalPERS.

23 The Capital Markets Creditors also misconstrue the nature of the financial obligations that the
24 City owes to CalPERS. So long as the City continues to participate in the system, it does not owe
25 CalPERS unfunded liability amounts or termination obligations in the millions or billions of dollars.
26 To that extent, it is inaccurate to state that CalPERS is presently the largest creditor of the City. The
27 City has a continuing obligation to fund its payments to CalPERS as determined by CalPERS’
28 actuaries. The City is in good standing with CalPERS and is current on its payments to the system.

1 Accordingly, there is no debt to CalPERS that will be adjusted in the City’s plan. The City’s
2 pendency plan, which is the predicate for its eligibility, contemplates the continuation of its
3 relationship with CalPERS. In connection with a plan that the City will ultimately propose, the Court
4 will consider the legal right of the City to exercise its business judgment to continue the relationship
5 and assume the obligations to CalPERS. The Court’s determination of the merits of the City’s
6 decision to assume this important relationship is properly brought in the context of confirmation of a
7 plan, but has no place in the consideration of the City’s eligibility for relief.

8 Nothing in the Bankruptcy Code requires that a municipality seeking protection under chapter
9 9 impair, seek to impair, or request impairment from, counterparties to its executory relationships in
10 order to be eligible. Indeed, the “good faith” requirement of section 109(c)(5)(B), by its plain terms,
11 requires only that the City negotiate in good faith with those creditors that it intends to impair at the
12 time of plan confirmation. This position is supported by the Bankruptcy Appellate Panel’s decision
13 in *In re City of Vallejo*, 408 B.R. 280 (9th Cir. BAP 2009) (“*Vallejo*”). Once Stockton made the
14 business decision to remain in the CalPERS system, the necessity of negotiations with CalPERS—if
15 it ever existed--ceased to exist. As demonstrated by the City’s submissions and supported by this
16 brief, the City has met its burden in support of its eligibility for relief. The Court should enter an
17 order for relief and allow the City to move forward with the proposal of its plan and the restructuring
18 of the City’s financial affairs.

19 **II. RELEVANT FACTUAL BACKGROUND**

20 **A. What Is CalPERS?**

21 CalPERS is an arm of the State of California, *i.e.* an agency that is an integral part of the
22 State, through which the State acts. *See* Cal. Gov. Code § 20002 (stating CalPERS “is a unit of the
23 State and Consumer Service Agency.”); *see also Barroga v. Bd. of Admin. of CalPERS*, No. 2:12-cv-
24 01179, 2012 WL 5337326 at *5 (E.D. Cal. Oct. 26, 2012) (finding that CalPERS is an “arm of the
25 state” for sovereign immunity purposes) (citing cases holding the same); *cf. CalPERS v. Moody’s*
26 *Corp.*, No. C09-03628, 2009 WL 3809816 at *6 (N.D. Cal. Nov. 10, 2009) (concluding CalPERS is
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1 “an arm of the state” for diversity jurisdiction purposes).³ Courts have recognized that the creation
 2 and implementation of State pension systems, like the CalPERS system, is an aspect of State
 3 sovereignty. *See, e.g., Feinstein v. Lewis*, 477 F. Supp. 1256, 1261 (S.D.N.Y. 1979) (emphasis
 4 added), *aff’d* 622 F.2d 573 (2d Cir. 1980) (quoting legislative history of ERISA to state that “State
 5 and local governments must be allowed to make their own determination of the best method to
 6 protect pension rights of municipal and state employees. These are questions of state and local
 7 sovereignty and the Federal Government should not interfere.”). As a result, the administration of
 8 California’s public retirement system is exempt from ERISA based, in part, on principles of
 9 federalism, especially the fact that State public employee retirement systems are shaped, in part, by
 10 the legislative process of the individual States. *See, e.g., Hightower v. Tex. Hosp. Ass’n*, 65 F.3d 443,
 11 448 (5th Cir. 1995) (noting public pension plans are exempt from ERISA “due to the resulting
 12 federalism implications.”); *Alley v. Resolution Trust Corp.*, 984 F.2d 1201, 1205 n.11 (D.C. Cir.
 13 1993) (R.B. Ginsburg, J.) (noting “[c]oncern about protecting state authority over relations with state
 14 employees was one reason for” the ERISA exemption of public plans); *Rose v. Long Island R.R.*
 15 *Pension Plan*, 828 F.2d 910, 914 (2d Cir. 1987) (“This Congressional reluctance to interfere with the
 16 administration of public retirement plans is in part based on principles of federalism.”).⁴

17 The Public Employees’ Retirement Law (Cal. Gov. Code, § 20000 *et seq.*) (“PERL”)
 18 establishes a retirement system for certain State and local government employees. *City of Oakland v.*
 19 *Pub. Emps. Ret. Sys.*, 95 Cal. App. 4th 29, 33 (2002). The purpose of the PERL is to “effect
 20 economy and efficiency in the public service” by providing a pension plan to pay retirement
 21 compensation and death benefits. Cal. Gov. Code § 20001; *see also Wheeler v. Bd. of Admin. of*
 22

23 ³ The California Attorney General recently affirmed its view that CalPERS is an “arm of the state.”
 24 *See* Lubic Dec., Exhibit 2 (relevant portions of State of California’s Complaint against Standard &
 25 Poor’s, filed Feb. 5, 2013) ¶ 37 (“PERS and STRS are arms of the State of California, operating
 under the California Constitution and the California Government Code.”).

26 ⁴ The administration of California’s public retirement system is exempt from the Employee
 27 Retirement Income Security Act (ERISA) based on principles of federalism, especially the fact that
 28 state public employee retirement systems are shaped, in part, by the legislative process. *See, e.g.,*
Rose, 828 F.2d 910 (2d Cir. 1987). This exemption of governmental plans from ERISA is codified in
 29 U.S.C. §§ 1002(32), 1003(b)(1).

1 *PERS*, 25 Cal.3d 600, 605 (1979) (“Pension programs for public employees serve two objectives: to
2 induce persons to enter into and continue in public service, and to provide subsistence for disabled or
3 retired employees and their dependants.”) (quotation and citation omitted). The California
4 Legislature established CalPERS in 1932 to provide retirement benefits to California State employees
5 and, in 1939, public agencies were allowed to participate. *See* Lubic Dec., Exhibit 3 (California
6 Public Employees’ Retirement System, Office of Public Affairs, Facts at a Glance: General (June
7 2012)). CalPERS provides pension fund and healthcare services for approximately 1.6 million
8 California public employees, retirees, and their families. *Id.* A “state employee generally becomes a
9 member of the Public Employees’ Retirement System ... ‘upon his or her entry into employment.’”
10 *Cal. Ass’n of Prof’l Scientists v. Schwarzenegger*, 137 Cal. App. 4th 371, 376 (2006). Local
11 government employers may participate in the CalPERS system to provide pension and retirement
12 benefits to their employees.

13 For public employees serving municipalities in California, CalPERS provides retirement
14 benefits to employees through a three-way structure: (1) the municipality has a “contract” with
15 CalPERS that triggers statutes and other laws governing the provision of pension benefits through
16 CalPERS; (2) the public servant has an employment contract with the municipality that includes
17 pension benefits; and (3) CalPERS has a fiduciary responsibility to provide and protect the pension
18 benefits of its employee members. This three-way structure is the basis for the trust relationship
19 between the parties where the municipality is the trustor, the members are the beneficiaries and
20 CalPERS is the trustee.

21 The CalPERS Board is governed by the California Constitution and statutes, such as Cal.
22 Const., art. XVI, § 17 subd. (b), which mandates that the CalPERS Board ensure the rights of
23 CalPERS members and retirees to their full earned benefits. *City of Oakland*, 95 Cal. App. 4th at 39-
24 40. In 1992, California voters approved Proposition 162, which gave the CalPERS Board exclusive
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1 authority over the administration and investment of pension funds.⁵ In enacting Proposition 162, the
 2 electorate amended article XVI, section 17 of the California Constitution, to read in part as follows:

3 Notwithstanding any other provisions of law or this Constitution to the
 4 contrary, the retirement board of a public pension or retirement system shall
 5 have **plenary authority and fiduciary responsibility** for investment of
 6 moneys and administration of the system, subject to ... the following: [¶] ...
 The retirement board shall ... have sole and exclusive responsibility to
 administer the system in a manner that will assure prompt delivery of benefits
 and related services to the participants and their beneficiaries.

7 *Bd. of Ret. of the Santa Barbara County Emps. Ret. Sys. v. Santa Barbara County Grand Jury*, 58
 8 Cal. App. 4th 1185, 1192 (1997) (emphasis added). Proposition 162 amended the California
 9 Constitution to provide that the CalPERS Board has “the sole and exclusive power to provide for
 10 actuarial services in order to assure the competency of the assets” of the system. Cal. Const., art.
 11 XVI, sec. 17, subd. (e). The intent behind the measure was to protect public pension funds by vesting
 12 the authority to direct actuarial determinations solely with the governing board. *See* Lubic Dec.,
 13 Exhibit 4 at 36 (Relevant Portions of Official Ballot Pamphlet (Nov. 3, 1992)). By granting the
 14 CalPERS Board sole authority to administer the system, Proposition 162 prevented the legislative and
 15 executive branches from “raiding” pension funds to balance the State budget. *Id.* at 38.

16 Moreover, the courts have recognized that pension plans create a fiduciary relationship
 17 between the system’s members (*i.e.*, employees) and the trustee of the funds. *Hittle v. Santa Barbara*
 18 *Country Employees Retirement Assn.*, 39 Cal. 3d 374, 391-93 (1985). The trustee must exercise this
 19 fiduciary trust “in good faith and must deal fairly” with the participants and beneficiaries. *Id.* at 392.
 20 In addition, the California Constitution cannot be interpreted to require CalPERS to administer the
 21 system to the advantage of the employer and at the expense of the beneficiaries to whom it owes a
 22 fiduciary duty. *City of Sacramento v. PERS*, 229 Cal. App. 3d 1470, 1493 (1991). The underlying
 23 principle of a pension system is “affording retirees with a reasonable degree of economic security.”
 24 *United Firefighters of LA v. City of LA*, 210 Cal. App. 3d. 1095, 1113 (1989).

25
 26
 27 ⁵ The ballot pamphlet accompanying Proposition 162 explained that pension system boards should
 28 give “highest priority” to providing benefits to members and their beneficiaries. *City of Oakland*, 95
 Cal. App. 4th at 54.

1 **B. The Need for Preservation of the Integrity of the State’s Public Employees’ Retirement System.**

2 1. *A Sound Public Pension System Benefits the State and its Citizens.*

3 In the late 1920s, the State of California created a Commission on Pensions of State
4 Employees to thoroughly investigate the establishment and structure of a statewide public retirement
5 system. *See* Chapter 431 of the Statutes of 1927. The Commission engaged in a comprehensive
6 process which included open meetings, study of other public retirement systems, analysis of existing
7 State employee data and questionnaires to develop a proposed framework. *See* Lubic Dec., Exhibit 5
8 at 5-7 (Relevant Portions of Report of the Commission on Pension of State Employees (December
9 31, 1928)). The Commission Report described the State’s public retirement system as a means “to
10 secure the improvement of its working personnel [concluding that] [a] sound retirement system
11 provides the state with a sure and just method of eliminating from its active force those employees
12 who have become incapable of performing their best work because of disability or superannuation.”
13 *Id.* at 8. The Commission Report emphasized that, with the increasing complexity of governmental
14 and regulatory functions, a sound retirement system helps recruit top-level talent for its workforce.
15 *Id.* at 9. For the retirement system to be an effective tool, the report stressed the need for the system
16 to have a “sound financial basis.” *Id.* This sentiment is as true now as it was then. California and its
17 citizens benefit when the State and its local municipalities are able to offer an overall competitive
18 compensation and benefits package. CalPERS is an integral part of that benefits package and this
19 only holds true only if the retirement system is able to fund the promised benefits.

20 Further, as Proposition 162 demonstrates, CalPERS and its authority are part of the State
21 political process. By removing the fiduciary responsibility from those elected officials that may be
22 presented with conflicting motives, California voters recognized the value of sustaining the
23 soundness of the fund. Vesting “plenary authority and fiduciary responsibility” with the CalPERS
24 Board is an expression of the political will of the people of California. Through the political process,
25 the voters took this authority away from the Legislature and the Governor and shifted it to the
26 CalPERS Board.

1 2. *An Actuarially Sound Pension System is Essential for the Payment of Pension*
 2 *Benefits.*

3 California courts acknowledge the value of safeguarding the funding of pension assets.
 4 Specifically, it has been held that members have a right to an actuarially sound retirement system and
 5 courts have a strong preference for interpreting the statutory pension provisions as guaranteeing
 6 adequate funding for full payment to participants and beneficiaries. *Bd. of Admin. v. Wilson*, 52 Cal.
 7 App. 4th 1109, 1131–32 (1997); *see also Valdes v. Cory*, 139 Cal. App. 3d 773, 785-86 (1983). The
 8 right to an actuarially sound system is “necessarily implied” from a public employer’s commitment to
 9 provide a pension benefit because otherwise the converse would impair the pension right. *Wilson*, 52
 10 Cal. App. 4th at 1133.

11 3. *California’s Expressions of Priority for Wages and Benefits.*

12 California has prioritized the payment of wages and benefits. Section 227 of the California
 13 Labor Code provides:

14 Whenever an employer has agreed with any employee to make payments
 15 to a health or welfare fund, pension fund or vacation plan, or other similar
 16 plan for the benefit of the employees, or a negotiated industrial promotion
 17 fund, or has entered into a collective bargaining agreement providing for
 18 these payments, it shall be unlawful for that employer willfully or with
 19 intent to defraud to fail to make the payments required by the terms of that
 20 agreement. A violation of any provision of this section where the amount
 21 the employer failed to pay into the fund or funds exceeds five hundred
 22 dollars (\$500) shall be punishable by imprisonment pursuant to
 23 subdivision (h) of Section 1170 of the Penal Code, or in a county jail for a
 24 period of not more than one year, by a fine of not more than one thousand
 25 dollars (\$1,000), or by both that imprisonment and fine. All other
 26 violations shall be punishable as a misdemeanor.

27 Cal. Labor Code § 227. Section 227 makes the failure to pay agreed-upon pension contributions a
 28 felony, establishes the maximum period of imprisonment for the offense, and establishes the
 29 maximum monetary fine for the offense. Lesser violations are punishable as misdemeanors, but
 30 failures to pay that exceed five hundred dollars are subject to more severe imprisonment. The fact
 31 that a willful violation of section 227 constitutes a criminal offense demonstrates that section 227 is a
 32 matter of statewide concern. *See In re Shaw*, 32 Cal. App. 2d 84, 86 (1939) (finding that because acts
 33 constituting criminal offenses under the laws of the state it “cannot now be said that the commission
 34 of such acts is strictly and solely a municipal affair”); *Fiscal v. City & County of San Francisco*, 158

1 Cal. App. 4th 895, 918-19 (2008) (finding comprehensive laws addressing firearm regulation in the
2 Penal Code supported that the matter was a statewide concern).

3 **C. The Nature of the City of Stockton’s Relationship with CalPERS.**

4 Under the PERL, a municipality may participate in the CalPERS system by entering into a
5 contract with CalPERS that describes the benefits to its employees and contributions required by the
6 municipality and its employees. Cal. Gov. Code § 20460. However, this “contract” is not of the
7 same character as a commercial contract; rather, it is an election into a statutory system of deferred
8 compensation. *See Jasper v. Davis*, 164 Cal. App. 2d 671, 675 (1958). Once a city makes this
9 statutory election, it is bound by the statutory provisions governing the system and the decisions of
10 the CalPERS Board. Cal. Gov. Code § 20506; *City of Oakland v. PERS*, 95 Cal. App. 4th 29, 55
11 (2002). Those provisions include prohibitions against failure to timely pay required employer
12 contributions and rejection of a contract or agreement under the bankruptcy provisions of chapter 9.
13 Cal. Gov. Code §§ 20831 & 20487. The courts view the statutory pension provisions as a
14 fundamental part of the employment relationship, which should be read to require adequate funds to
15 meet reasonable expectations of the employees. *Valdes*, 139 Cal. App. 3d at 786. Participating cities
16 cannot alter their funding obligation to CalPERS. *Wilson*, 52 Cal. App. 4th at 1122.⁶

17 For this reason, the City’s obligations to CalPERS are not defined by the language of its
18 agreements with CalPERS; rather, they are defined by law. The CalPERS Board is solely responsible
19 for “management and control of th[e] system.” Cal. Gov. Code § 20120. The CalPERS Board must
20 keep “data necessary for the actuarial valuation of the system,” and in accordance with that data,
21 adopt annual and actuarial interest rates. *Id.* §§ 20131–32. To make these calculations, the CalPERS
22 Board may employ an actuary who will actuarially value the assets and liabilities of the system. *Id.*
23 §§ 20015 & 20133.

24 The PERL requires an agency participating in the CalPERS system to make timely
25 contributions for employees in amounts recommended by CalPERS’ actuary and approved by the

26
27 ⁶ As discussed more fully below, a participating agency may elect to terminate its participation in the
28 retirement system prospectively, but such termination does not affect contribution obligations for
benefits accrued prior to termination. *See* Cal Gov. Code § 20570.

1 CalPERS Board. Cal. Gov. Code §§ 20532 & 20831. The PERL explicitly provides that a
2 participating agency may not refuse to pay the required contributions as determined by CalPERS
3 within the prescribed deadlines. *Id.* at § 20831. A participating agency is also responsible to
4 CalPERS for the expenses of determining the approximate and actual contributions, as well as of
5 administering the CalPERS system. *Id.* at §§ 20535 & 20536.

6 In September 1944, the City of Stockton, through its City Council, elected to participate in the
7 California State Retirement System, subject to the provisions of the State Employees' Retirement
8 Act. *See, e.g.*, Exhibits 232, 233 & 234 (Stockton/CalPERS Original Contract & Amendments).⁷
9 The City has two subplans with different benefit formulas—safety workers and miscellaneous
10 employees. *See id.* & Exhibits 422 & 423 (Annual Valuation Report as of June 30, 2011 for the
11 Miscellaneous and Safety Stockton Plans). All City employees who are not safety workers are part of
12 the miscellaneous subplan and all contributions made to this subplan are allocated to this subplan as a
13 whole. *See id.*

14 **D. Explanation of the Nature of Certain Calculated Liabilities.**

15 Throughout this bankruptcy case, the Court will hear numerous terms that relate to how
16 Stockton's payments to CalPERS are calculated. While these terms may be common to those versed
17 in actuarial science, CalPERS provides an explanation on how Stockton's contributions to the
18 CalPERS system are calculated as this is important in order to understand the nature of the City's
19 financial obligations to CalPERS relevant to the bankruptcy process.

20 The City's ongoing obligations to contribute to CalPERS are determined on an actuarial basis
21 taking into account expected investment returns, employee life expectancy, projected retirement date
22 and projected compensation. All actuarial calculations are based on a number of assumptions about
23 the future: (a) demographic assumptions include the percentage of employees that will terminate, die,
24 become disabled, and retire in each future year and (b) economic assumptions include future salary

25 _____
26 ⁷ CalPERS will seek to coordinate with Assured on the assembly and delivery of a joint exhibit
27 binder related to exhibits referenced in this brief and that of Assured or will in the alternative provide
28 copies of the exhibits referenced in this brief to the Court, the Debtor and the Capital Markets
Creditors in advance of the eligibility status conference.

1 increases for each active employee and future investment returns. *See* Declaration of David
 2 Lamoureux (“Lamoureux Dec.”), ¶ 5. The basic premise of a defined benefit pension plan is that the
 3 payments are determined based on actuarial assumptions and calculations and the risk is pooled
 4 among the participants in the plan. For a homogeneous population, predictions for larger groups are
 5 more accurate than for smaller groups. Accordingly, as a pool is made larger and larger, the volatility
 6 of the cost per member decreases because the risk is pooled among a larger group. *Id.* at ¶ 6.

7 The term “Employee Contribution,” which is also known as a “Member Contribution,” is an
 8 amount set by a California statute and refers to the amount of money an individual employee must
 9 contribute through each paycheck to be in the CalPERS system. Lamoureux Dep. 39:16-25 & 40:1.⁸
 10 The term “Employer Contribution Rate” is an amount that is set by the CalPERS actuarial staff on an
 11 annual basis. Because each employee member is guaranteed a certain level of benefits, the Employer
 12 Contribution Rate can vary from year to year based on investment performance. *Id.* at 40:2-7 &
 13 41:12-16. An Employer’s Contribution Rate is annually calculated and is based on a percentage of
 14 payroll. Lamoureux Dec., ¶ 8.

15 The most recent Annual Valuation Reports for the City of Stockton, *see* Exhibits 422 & 423,
 16 which cover the valuations as of June 30, 2011, are prepared by CalPERS’ actuaries to:

- 17 (1) Set forth the actuarial assets and accrued liabilities of each plan as of June 30, 2011;
- 18 (2) Determine the required Employer Contribution Rate for each plan for the fiscal year
 19 July 1, 2013 – June 30, 2014;
- 20 (3) Provide actuarial information as of June 30, 2011 to the CalPERS Board of
 Administration and other interested parties; and
- 21 (4) Provide pension information as of June 30, 2011 to be used in financial reports subject
 22 to Governmental Accounting Standards Board Statement 27 for a single employer
 defined benefit pension plan.

23 Lamoureux Dec., ¶ 9. In these Reports, the actuarial valuations provide the following funding and
 24 rate information for fiscal years 2010 and 2011:

- 25 (1) The actuarial and market value of the assets;

27
 28 ⁸ Cited portions of the deposition of David Lamoureux are attached as Exhibit 6 to the Lubic Dec.

1 (2) The current unfunded liability; and

2 (3) The funded ratio.

3 For fiscal years 2012 and 2013, the reports provide projected Employer and Employee Contribution
4 Rates for service credit earned during the applicable periods. Lamoureux Dec., ¶ 10.

5 For any given year, contribution amounts are calculated by adding together two different
6 elements: (1) The “Normal Cost,” which means “the cost of providing one year of benefits to the
7 current employees.” Lamoureux Dep. 44:3-5. In other words, it is the plan’s annual premium for
8 service earned in the upcoming year in the absence of any unfunded or overfunded liability to be
9 amortized. It is expressed as a percentage of payroll. Lamoureux Dec., ¶ 11; and (2) Payment
10 toward any “Unfunded Accrued Liability,” which is obtained by comparing the assets of the plan to
11 the actuarial accrued liability of the plan (*i.e.* the present value of the benefit for all credited past
12 service of current members). *Id.* at 11. Unfunded Accrued Liability is expressed as a lump sum
13 dollar amount. *Id.* at ¶ 11.

14 The Unfunded Accrued Liability calculations as described in the Annual Valuation Reports
15 are not a reflection of any amounts that are currently owed by an employer. Unfunded Accrued
16 Liability is simply a component of the actuarial calculation used to determine the employer
17 contribution rate for upcoming fiscal year. *Id.* at ¶ 12.⁹ The annual contribution is borne by both the
18 employer and the employees and the future benefits for current employees will be assured only if all
19 contributions of both employer and employees are made timely and in full. *Id.* at ¶¶ 13-14.

20 Finally, in the event of termination,¹⁰ a terminated agency is required to make a payment to
21 CalPERS in an amount determined by the CalPERS Board (based on actuarial information) to be
22 sufficient to ensure payment of all vested pension rights of the terminated agency’s employees
23 accrued through the termination date. This is referred to as the “Termination Payment.” Lamoureux
24 Dec., ¶ 15. The Termination Payment is due immediately and is subject to interest and is more fully
25 discussed below. Cal. Gov. Code § 20577 & Lamoureux Dep. 191:17-23.

26 ⁹ According to the most recent Annual Valuation Reports, the City must pay CalPERS
27 approximately \$29.5 million during the 2012-13 fiscal year in order to remain current on its payments
28 to CalPERS. *See* Exhibits 422 at 5 & 423 at 5 (“Total Employer Contribution” line item).

¹⁰ *See infra* Section II.E (discussing termination).

E. The Termination Process and the Consequences of Termination.

1 Throughout their objections, the Capital Markets Creditors repeatedly refer to the fact that
 2 Stockton has the ability to terminate its relationship with CalPERS. This argument is a red herring.
 3 While it may be technically correct that Stockton can terminate its relationship with CalPERS, the
 4 Capital Markets Creditors are laboring under a misconception that somehow Stockton or CalPERS
 5 had the ability to negotiate the terms and conditions of termination, including the amount of the
 6 Termination Payment. *See, e.g.*, National Objection [Dkt. No. 477] at 13, ¶ 48 (“Given that the
 7 PERL permits CalPERS to terminate the City’s contracts and transfer its plan assets and liabilities to
 8 the terminated agency pool . . . the City could have, at a minimum, requested CalPERS to do so and
 9 attempted to negotiate reduced contribution rates for existing and future retirees.”). The required
 10 payment upon termination is not, however, subject to negotiation.

11 *1. Termination and the Termination Process.*

12 As set forth in the PERL, some circumstances allow for the termination of the relationship, or
 13 a portion thereof, between a contracting agency¹¹ and CalPERS. For instance, contracts which have
 14 been in effect for at least five years can be terminated through approval of an ordinance or resolution
 15 of the contracting agency’s governing body, or through an ordinance adopted by the electorate, with
 16 one year’s notice to CalPERS. Cal. Gov. Code §§ 20570 & 20571. Also, if a contracting agency
 17 fails to pay its required periodic contributions within 30 days after demand by the CalPERS Board, or
 18 fails to file any information required in the administration of the system, or if the CalPERS Board
 19 determines the contracting agency no longer exists, the CalPERS Board may terminate the contract
 20 by resolution. Cal. Gov. Code § 20572.

21 In the event of termination, a terminated agency is required by law to make a payment to
 22 CalPERS in an amount determined by the CalPERS Board (based on actuarial calculations) to be
 23 sufficient to ensure payment of all pension benefits of the terminated agency’s employees accrued
 24 through the termination date. Cal. Gov. Code § 20577. The Termination Payment is due
 25 immediately and subject to interest. *Id.* (“The amount of difference shall be subject to interest at the
 26

27 ¹¹ “Contracting agency” means, among other entities, any public agency that has elected to have all
 28 or any part of its employees become members of this system and that has contracted with the board
 for that purpose. *See* Cal. Gov. Code § 20022.

1 actuarial rate from the date of contract termination to the date the agency pays this system.”). The
2 Termination Payment goes into the “Terminated Agency Pool.” Cal. Gov. Code § 20577.5.

3 In making this calculation, CalPERS is subject to investment risk, longevity risk and wage
4 fluctuation risk associated with the future payment of the terminated agency’s benefits. Unlike in an
5 ongoing plan, these risks cannot be addressed by adjusting contribution rates in future years. Because
6 there is no mechanism for receiving additional payments should the actuarial assumptions not be met,
7 the investments in the Terminated Agency Pool, and the assumptions to determine the Termination
8 Payment, must be more conservative. To address the longevity risk, the Termination Payment
9 calculation includes an increase to the liabilities to address mortality fluctuations. Cal. Gov. Code
10 § 20576. In addition, the CalPERS Board has adopted a policy to determine the discount rate,
11 inflation assumption and wage growth assumption for termination calculations aimed at protecting
12 the pension system from investment risk, inflation and wage growth changes. *See* Lubic Dec., Exhibit
13 11 (CalPERS Circular Letter No. 200-058-11 (August 19, 2011)) & Exhibit 12 (Aug. 2011 Agenda
14 Item). In addition, the CalPERS Board recently adopted a conservative asset allocation for the
15 Terminated Agency Pool, which helps the pool’s funds given that CalPERS has no further recourse to
16 a terminating employer once the Termination Payment is made and contributed to the pool. *See*
17 Lubic Decl., Exhibit 13 (Dec. 2012 Agenda Item) & Lamoureux Dep. 110:6-25, 111:1-25 & 113:3-
18 24.

19 A primary driver in determining the amount of the Termination Payment is the setting of the
20 discount rate, which is “a reflection of the asset policy or how the assets are invested.” *Id.* at 190:15-
21 17. Given the conservative nature of the investments in the Terminated Agency Pool, the discount
22 rate related to a Termination Payment is low when compared with the actuarial rate for the portfolio
23 for ongoing participating agencies. *Id.* at 190:15-25 & 191 1-15. The cumulative effect of these
24 policies is that a terminated agency’s actuarial liability upon termination is significantly larger than
25 the actuarial liability on an ongoing basis.

26 Stockton’s 2011 Annual Valuation Reports each provide a line item for “unfunded
27 termination liability,” which is an estimate as to how much Stockton would owe to CalPERS if its
28 contracts had been terminated as of *June 30, 2011*. The Miscellaneous Plan lists this liability at

1 \$357,707,135 and the Safety Plan lists this liability at \$588,422,928, which totals almost \$950
2 million. *See* Exhibit 422 at p. 15 & Exhibit 423 at p. 15.¹² If a terminated agency fails to pay the
3 Termination Payment, benefits under the contract must be reduced pro rata based on the amount of
4 the Termination Payment that is not funded.¹³ Cal. Gov. Code § 20577. This is a one-time
5 opportunity for CalPERS to reduce the benefits payable under the terminated contract. *Id.* Once the
6 terminated agency's assets and liabilities have been merged into the Terminated Agency Pool
7 account, no further benefit adjustments are permitted under the PERL. Ultimately, it is probable that
8 the CalPERS general pool—all of the funds of all the participating employers—bears the risk if there
9 are not enough assets to pay the benefits under the terminated contract. Accordingly, a shortfall
10 shifts the burden not only to Stockton members, but also to other municipalities and the State,
11 together with all of their members.

12 2. *Termination is Not a Viable Option.*

13 Given that Stockton could not have negotiated the amount of any Termination Payment with
14 CalPERS, it is irrelevant to this Court's eligibility determination what the actual consequences of
15 termination would have been. Nevertheless, given the dogged focus of the Capital Markets Creditors
16 on termination, it is useful to understand the consequences of termination to underscore the weakness
17 inherent in the Capital Markets Creditors' argument.

18
19 ¹² When a contracting agency terminates its relationship with the retirement system, the PERL
20 specifically provides that the terminated agency is liable to CalPERS for the Termination Payment
21 and costs of collection, including attorney's fees. Cal. Gov. Code § 20574. This section of the PERL
22 also grants a lien in favor of CalPERS "on the assets of a terminated contracting agency, subject only to
23 a prior lien for wages." *Id.* Based on the legislative history, the intent of this section (adopted in
24 1982) was to elevate CalPERS' rights from that of a general unsecured creditor to that of a senior
25 secured creditor as a matter of law. The legislative history contains discussion of the intent to "grant
26 PERS a lien against the assets of public agencies who have terminated their membership in the
27 system, usually as a result of agency dissolution and bankruptcy who have unfunded liabilities owed
28 to PERS for vested employee benefits and have no ability to pay such liabilities." The legislative
29 history goes on to indicate that under then existing law, CalPERS was only an unsecured creditor.
30 *See* Lubic Dec., Exhibit 7 at 35 (Relevant Portions of Legislative History to Cal. Gov. Code §
31 20574).

32 ¹³ CalPERS may choose to make no reduction or a lesser reduction if the CalPERS Board has made
33 reasonable efforts to collect the payment and the CalPERS Board determines that failure to make
34 a reduction will not impact the actuarial soundness of the Terminated Agency Pool account. Cal.
35 Gov. Code § 20577.5.

1 Because the City has continued to make its monthly payments to CalPERS, the only way the
2 City's contract with CalPERS can be terminated is if the City itself chooses to request termination. If
3 Stockton chose to terminate its relationship with CalPERS, the City would be faced with an
4 immediately due and owing massive termination liability. Based on the City's most recent Actuarial
5 Valuation Reports, the City would face an immediately due liability of approximately \$950 million
6 upon termination of its CalPERS contract. Given that this calculation was made based on a
7 hypothetical termination date of June 30, 2011, due to the subsequent decrease in market interest
8 rates, the amount of Stockton's termination payment would likely have been even greater if it
9 terminated during the AB 506 process. *See* Lamoureux Dep. 110:6-25 & 111:1-25. Obviously, the
10 almost \$950 million figure (or some larger amount) is far larger than the City's current ongoing
11 payment obligations and would cause a far more significant adverse impact to its financial
12 condition.¹⁴ Consequently, termination provides no advantage, either to the City itself or to its
13 various creditors, including the Capital Markets Creditors, and this is particularly so because under
14 the PERL not only is a terminating agency liable for various fees and costs but also is subject to a
15 senior priority secured lien in the amount of the Termination Payment.

16 Put simply, the actuarial calculation that makes up the Termination Payment is not negotiable
17 because it is based on statutorily required Board policies which are necessarily guided by CalPERS'
18 statutory and constitutional mandates to act as a fiduciary of the system as a whole.

19 3. *Funded Status of the Termination Pool and Availability of an "Alternate*
20 *Plan."*

21 National makes much of the fact that (1) the Terminated Agency Pool is currently
22 approximately 200% funded; and (2) that Stockton's pension plans can simply be "replaced by new
23 affordable defined benefit plans." *See* National Supplemental Objection [Dkt. No. 635] at 13. Both
24 of these assertions are misleading.

25
26 ¹⁴ Indeed, the almost \$950 million (or some larger figure) would be more than double than the
27 estimated \$350 million (excluding the amounts the City attributes to CalPERS) owed to other
28 creditors listed on the City's List of Creditors Holding 20 Largest Unsecured Claims [Dkt. No. 4]
making the termination liability claim approximately 73% of the unsecured pool. As noted earlier,
however, the termination claim is secured, not unsecured.

1 First, although the Terminated Agency Pool is currently superfunded, it is funded by
2 termination payments of a number of small employers such that the total assets of the pool are
3 relatively small. *See, e.g.*, Lamoureux Dep. 97:6-23. Indeed, the total assets currently in the
4 Terminated Agency Pool are dwarfed by the payment Stockton would be required to make if it
5 terminated its relationship with CalPERS. Stockton's size as a large employer, and the magnitude of
6 its unfunded termination liabilities, would overwhelm whatever surplus the pool now enjoys. This
7 result would provide no benefit to the City's employees and could prevent employees of other
8 agencies in the pool from collecting their full share of accrued benefits. Obviously, Stockton does
9 not currently have almost \$950 million (or more) to pay its Termination Payment. Placing Stockton's
10 employees into the Terminated Agency Pool would no doubt materially adversely alter the funding
11 level of the pool based on the hypothetical Termination Payment as of June 30, 2011.

12 CalPERS cannot simply choose to reduce benefits as a means to reduce the City's obligations
13 under its CalPERS contract. *See, e.g.*, Cal. Gov. Code § 20475. CalPERS has no statutory authority
14 to impose a benefit reduction unilaterally; instead, CalPERS may reduce benefits only upon the
15 termination of an agency's contract. Cal. Gov. Code § 20577.5. Moreover, in a termination,
16 CalPERS may maintain benefits without reduction only if the Board finds that this will not impact the
17 actuarial soundness of the Terminated Agency Pool. *Id.* In this case, however, as described above,
18 merger of the City's plan into the pool would significantly impact the actuarial soundness of the pool,
19 given the size of the plan and its unfunded status. As a result, if Stockton cannot fund its shortfall,
20 CalPERS would be required to reduce benefits accordingly before merging Stockton's assets into the
21 Terminated Agency Pool.

22 Second, with respect to "new affordable defined benefits plans," the capital markets parties
23 offer absolutely no evidence that any such plans actually exist.¹⁵ Surely, if such plans existed, the
24 Capital Markets Creditors would have provided evidence of such plans to the Court. Further, if the
25

26 ¹⁵ Even if such an alternative plan were to exist, query how much value an employee would place on
27 the benefits of such an alternative system, given that the City had terminated its plan with CalPERS
28 causing massive retroactive reductions in benefits. Wouldn't an employee suspect that the alternative
system could also be arbitrarily terminated?

1 City chooses to terminate its relationship with CalPERS, the City could not renew its relationship
2 with CalPERS for at least three years from the date of termination. Cal. Gov. Code § 20460. During
3 this time, the City would have no viable alternative for providing benefits to its employees. Although
4 the City's existing employees that had benefits accrued as of the termination date in CalPERS would
5 retain their benefits (albeit likely reduced dramatically), they would earn no additional benefits, and
6 new employees would have no retirement system in which to participate. Such a situation would
7 undoubtedly impact Stockton's ability to retain and hire new employees and further impair its ability
8 to provide essential services to its residents.

9 Terminating its relationship with CalPERS during the AB 506 process was simply not a
10 viable option for the City because it would have given rise to an enormous Termination Payment
11 obligation, the amount of which is not subject to negotiation. As explained more fully below, once
12 Stockton made the decision to remain in the CalPERS system, it was under no obligation to negotiate
13 with CalPERS. The Capital Markets Creditors fixation on termination is a mere distraction to the
14 ultimate question of whether Stockton is eligible for protection under chapter 9.

15 **F. CalPERS Has Limited Flexibility in Setting Contribution Rates.**

16 CalPERS' relationship with its members, which include the City, is governed by both
17 California statutes and the California Constitution. In essence, both the PERL and the California
18 Constitution establish a set of rules that govern the relationship among CalPERS, contracting
19 agencies (like the City), and employee members of the system. In addition, CalPERS is further
20 constrained by federal tax law.

21 *1. The PERL Specifies Benefit Formulas Which Cannot Be Reduced Through*
22 *Negotiations.*

23 The PERL provides a finite array of benefit formulas for contracting agencies to elect for its
24 employees. Cal. Gov. Code § 21350 *et seq.* Stockton has chosen the 2% at age 55 benefit and 2% at
25 age 60 benefit for its miscellaneous employees and the 3% at age 50 benefit for its safety workers.
26 Cal. Gov. Code §§ 21353, 21354 & 21362.2. Once a municipality makes an election, it is irrevocable
27 and benefits provided by the election can only be increased. Cal. Gov. Code § 20474 ("Any election
28 made by amendment to the contract shall be irrevocable until the contract is terminated. However,

1 benefits provided by the amendment may be increased or improved from time to time by further
2 amendment to the contract.”). A municipality, however, may amend its contract to reduce benefits,
3 terminate provisions or provide for different benefits, but only for new employees and employees
4 who switch classifications. Cal. Gov. Code § 20475(b) (“A member shall be subject to the contract
5 as amended only if, after the effective date of the contract amendment, the member either (1) receives
6 service credit for the first time within a classification, or (2) the member returns to service with a
7 classification following termination of membership[.]”). As explained in detail above, CalPERS only
8 has the ability to reduce benefits through the termination process.

9 In addition, under California law, pension benefits are considered “vested rights” and
10 therefore neither Stockton nor CalPERS can unilaterally adjust those benefits because to do so may
11 violate the Contracts Clause of the United States and the California Constitutions. *See Betts v. Bd. of*
12 *Admin.*, 21 Cal.3d 859, 863, 867 (1978). In fact, under California law, promised benefits may not be
13 decreased without a comparable new advantage. *See, e.g., United Firefighters of Los Angeles City v.*
14 *City of Los Angeles*, 210 Cal.App.3d 1095, 1103 (1989). Given this, CalPERS lacks the authority,
15 absent specific statutory provisions, to unilaterally decrease pension benefits, even if a request to do
16 so comes from a financially distressed city like Stockton.

17 The Capital Markets Creditors argument that a “modest” reduction of pension benefits would
18 be acceptable completely ignores this State law backdrop against which any modifications to benefits
19 must be viewed. Put simply, any unilateral reduction in benefits, whether by the City or by CalPERS,
20 would violate State law. Thus, even if Stockton had asked CalPERS for a “modest” reduction in
21 pension benefits, CalPERS lacked the statutory authority to grant any such request, even if this
22 request occurred within the process of pre-bankruptcy negotiations. This is a point that the Capital
23 Markets Creditors refuse to accept, perhaps because it is fatal to their claim that the City did not
24 negotiate in good faith.

25 2. *Hardship Extension.*

26 While CalPERS lacks the authority to unilaterally change pension benefits and must be
27 cognizant of the federal tax rules, CalPERS does have the ability to provide the option for contracting
28 agencies experiencing financial difficulties to request what is commonly referred to as a “hardship

1 extension.” A hardship extension allows an agency to re-amortize the agency’s unfunded liability.
2 *See* Cal. Gov. Code § 20812. This hardship extension period is set by statute and limited to 30 years.
3 *Id.* Assured, in a footnote and without citation, claims that “CalPERS’ governing statute gives its
4 board broad discretion to work with municipalities, to adjust discount rates, and to stretch repayment
5 horizons, and the City’s failure to even request a hardship exemption from CalPERS indicates it was
6 not interested in even exploring any options CalPERS might be able to facilitate.” Assured
7 Supplemental Objection [Dkt. No. 638] at 27 n.18. This is not so and appears to be based on the
8 erroneous assumption that such requests are granted as a matter of course. As with termination, the
9 decision to deny or accept a hardship extension is not subject to negotiation. CalPERS’ decision to
10 grant a hardship extension must be guided by its fundamental duty to maintain and protect the
11 actuarial soundness of the system and to preserve its members’ benefit levels.

12 The CalPERS Board intends that the amortization extension policy will eliminate unfunded
13 liabilities “in a manner that maintains benefit security for the members of the System while
14 minimizing substantial variations in employer contribution rates.” *See* Exhibit 510 (30 Year
15 Amortization Extension Policy Guidelines, CalPERS (Sept. 14, 2010)). An agency requesting an
16 extension must demonstrate its need for financial relief by submitting the following:

- 17 (1) A statement of hardship from the employer;
- 18 (2) A statement that the employer has notified employees or employee groups
19 of the request for an extension of the employer’s amortization period; and
- 20 (3) A statement that the employer is aware of the potential for a reduction in
21 benefits in the event that the employer terminates the plan without
22 providing continuation of funding adequate to fully fund the liabilities
23 upon termination.

24 Nevertheless, even if the agency is in genuine financial need, it also must demonstrate that the
25 extension will actually provide relief. Agencies unfunded liabilities are subject to varying rates of
26 amortization, depending on the cause of the unfunded status.

27 Agencies have multiple factors contributing to their overall unfunded liability, and each
28 portion attributable to a different factor also is likely subject to a different amortization rate. For
example, an unfunded liability resulting from a change in plan provisions or actuarial assumptions is
subject to a 20-year amortization period, while a liability resulting from an investment gain or loss is

1 subject to a 30-year period. *See* Exhibit 507 (CalPERS Board Resolution No. ACT-96-O5E, revised
2 April 2005). To determine the agency's overall average amortization period, CalPERS averages the
3 periods associated with the different sources on a pro rata basis. Only if an agency's average period
4 is significantly less than 30 years is a hardship extension appropriate. According to CalPERS policy,
5 "if the current net amortization period is already near 30 years, then extending to 30 years will not
6 produce measurable rate relief and is unwarranted." *See* Exhibit 509 (CalPERS 30 Year
7 Amortization Extension Policy Guidelines (Feb. 19, 2003)); *see also* Exhibit 510 (CalPERS Review
8 of 30 Year Amortization Extension Policy Guidelines (Sep. 14, 2010)).

9 In addition to the degree of relief obtainable by an extension, the CalPERS Chief Actuary also
10 must consider whether reducing the agency's contribution rate will produce long-term harm to the
11 agency's plan. To make this determination, the CalPERS Chief Actuary likely will review estimates
12 of the plan's future cash flows and its future funded status, and it will weigh these factors against the
13 likelihood that the plan would be able to cover all liabilities in the event of plan termination without
14 any benefit reductions. Historically, when denying a hardship extension request, the CalPERS Chief
15 Actuary has done so due to concerns about the contracting agency's ability to pay its future
16 contributions, even subject to the extended amortization period. In other words, the granting of a
17 hardship extension is subject to credit analysis.

18 On December 4, 2012, Stockton made a formal request to CalPERS for a hardship extension.
19 After reviewing Stockton's request, on January 2, 2013, CalPERS informed the City that the City's
20 request, in its current form, did not meet the necessary criteria because "[t]he plans' assets were not
21 sufficient to cover all plan liabilities on a termination basis as of June 30, 2011 as was shown in the
22 hypothetical termination liability calculation included in the most recent actuarial valuation report."
23 *See* Lubic Dec., Exhibit 8 (Jan. 2 email from CalPERS to Stockton). In so stating, CalPERS
24 informed the City that it could provide additional information to support its current request. *See id.*
25 In addition, CalPERS informed the City that an "exception" exists to the requirements Stockton
26 initially failed to meet noting the exception's language:

27 If the plan's assets will not be sufficient, other factors will be considered on a case
28 by case basis based on the specific facts and circumstances of each request,
including without limitation, the likelihood of the employer terminating its

1 contract, the employer's ability to provide continuation of funding at termination,
2 whether annual contributions continue to and are projected to continue to exceed
benefits paid to retirees and beneficiaries, and/or whether the rate of relief would
have a material impact on the plan's funded status.

3 *Id.* After noting the exception, CalPERS invited the City to provide additional documentation to
4 determine whether it qualified under the exception, noting that it "would be pleased to review any
5 such submission." *Id.*

6 3. Potential Jeopardy to Tax Exempt Status.

7 In addition to these State law constraints, any unilateral reduction of pension benefits by
8 CalPERS may ultimately impact the federal tax treatment of CalPERS' members' benefits. A tax-
9 qualified pension plan must comply with its terms to maintain tax-qualified status. If a tax-qualified
10 plan's operation does not comply with its terms, the plan has an operational failure that could
11 jeopardize the plan's tax-qualified status. *See* Lubic Dec., Exhibit 9 (Rev. Proc. 2008-50, Section
12 5.01(2)(b), 2008-35 I.R.B. 464). In the case of CalPERS, the PERL and the relevant parts of the
13 California Code of Regulations serve as the official plan document. *See, e.g.*, Cal. Gov. Code
14 § 20003. Thus, CalPERS and its Board cannot take any action under the plan that is not authorized
15 by the PERL without jeopardizing the tax-qualified status of the plan.

16 Further, a tax-qualified plan may not violate prohibited transaction rules. Governmental plans
17 that are tax-qualified are subject to the prohibited transaction rules of Section 503 of the Internal
18 Revenue Code of 1986, as amended (the "IRC") and, if violated, the plan may lose its tax-qualified
19 status. IRC Section 503(a)(1)(B). This section of the IRC generally requires arm's-length dealings
20 between the creator of the trust and the trustee. *See* Lubic Dec., Exhibit 10 (General Counsel
21 Memorandum 38972 (Mar. 25, 1983) (citing S. Rep. No. 2375, 81st Cong., 2d Sess. 36-37, 1950-2
22 C.B. 483, 509-511)). The prohibited transactions include: (1) the lending of any part of the trust
23 income or corpus without the receipt of adequate security and a reasonable rate of interest to the
24 creator or contributor, (2) the substantial purchase of securities or other property for more than
25 adequate consideration from the creator or contributor, and (3) the sale of a substantial part of its
26 securities or property for less than adequate consideration to the creator or contributor. IRC Section
27 503(b)(1), (4) and (5).

1 Any restructuring of CalPERS' members' benefits could potentially violate the prohibited
2 transaction rules of IRC Section 503 if the restructuring applies to contributions already owed. The
3 IRS has issued guidance regarding a City's delay in making immediate cash contributions for which
4 it was currently liable and held that "a loan may be implied and . . . transactions must be viewed
5 according to their real nature rather than mere form." See Lubic Dec., Exhibit 10 (General Counsel
6 Memorandum 38972 (Mar. 25, 1983) (citing *Fuqua Nat'l, Inc. v. United States*, 334 F. Supp. 1116
7 (S.D. Ga. 1971)). Loss of tax-qualified status would mean that all members would have immediate
8 tax liability.¹⁶ The IRS treats a plan as disqualified for all plan years after an error has occurred until
9 the error is corrected. Under this approach, a disqualification error that occurred prior to the open tax
10 years (*i.e.*, occurred in years for which the statute of limitations has run) can cause the plan to be
11 treated as disqualified in the open years if the IRS identifies the error. If a plan is disqualified for
12 some or all open tax years, the employer, the plan participants, and the plan trust may suffer
13 significant negative consequences.

14 In essence, any restructuring of CalPERS' members' benefits has the potential to cause great
15 financial harm to the both the City and its employees and retirees, as well as the State of California
16 itself, because it may jeopardize the tax-exempt status of CalPERS.

17 **G. The City Has Made Requests to Modify Its CalPERS Contract in Compliance**
18 **with the PERL.**

19 As noted above, while the relationship between Stockton and CalPERS is initiated by a
20 contract, the terms of the contract are enforced by applying the applicable provisions of the PERL.
21 The PERL constitutes a set of ground rules that governs the relationship between CalPERS and
22 participating cities, including the City. Deviation from this set of rules is not permissible under

23 ¹⁶ First, to the extent taxes were owed, the sponsoring employer may risk liability for failure to
24 withhold and remit income, FICA, and FUTA taxes on vested contributions and earnings owned by
25 the employees. Second, if a plan loses its qualified status, the plan trust might be required to pay
26 taxes and penalties on the investment earnings earned during the disqualified years. Finally, to the
27 extent that employees are vested or became vested in contributions made in (or with respect to) the
28 disqualified years, they may owe income and FICA taxes on such contributions and associated
investment earnings. In addition, plan participants may also owe penalties for failure to pay taxes on
their income in a timely manner. Former employees who received distributions from the plan during
the disqualified period must pay taxes on the entire amount of the distribution, even if they rolled the
distribution over to another plan or IRA.

1 California law and therefore not subject to negotiation. While the Capital Markets Creditors either
2 fail to grasp this fact or simply fail to acknowledge it because it is an inconvenient truth that
3 undercuts the entire premise of their “good faith” arguments, Stockton understands this reality as
4 evidenced by actions it has taken over the past eight months.

5 Throughout this process, the City has complied with applicable rules when requesting an
6 alteration in the benefits to its employees, both past and present. For example, prior to filing for
7 chapter 9 relief, on June 7, 2012, the City made a request of CalPERS to initiate conversations to
8 understand what the potential savings would be, and how the process would work, for the City to
9 limit the annual Cost-of-Living Adjustment (“COLA”) for its miscellaneous employees from five to
10 two percent. *See* Exhibit 183 (June 7, 2012 letter from Stockton to CalPERS). On July 3, CalPERS
11 responded to the City’s request and noted that “[w]hile CalPERS wishes to be cooperative with the
12 City as it seeks to address its fiscal difficulties, the System lacks the authority to grant the City’s
13 request on this issue.” Exhibit 184 (July 3, 2012 letter from CalPERS to Stockton). In so doing,
14 CalPERS pointed to various sections of the PERL, as well as the “vested rights” doctrine, as the basis
15 for denying Stockton’s pre-bankruptcy filing request. *See id.* Likewise, after this request, Stockton
16 made a request to add an exclusion to the City’s retirement contract, which sought to exclude elected
17 officials from coverage. On September 21, 2012, CalPERS granted the amendment request and noted
18 that the exclusion was “prospective only” and would not “apply to current elected officials who are
19 already members of the system.” Exhibit 424 (Sep. 21, 2012 letter from CalPERS to Stockton).

20 **H. CalPERS Participated in the AB 506 Process.**

21 At the initiation of the AB 506 process, the City invited CalPERS, along with other creditors,
22 to participate in the AB 506 process. CalPERS attended mediation sessions and meetings of creditors
23 through its general counsel and outside counsel as requested by the mediator and the City.

24 **III. ARGUMENT**

25 The Capital Markets Creditors’ arguments that the City lacks good faith, whether under
26 section 109(c)(5)(B) or section 921(c) of the Bankruptcy Code, are without merit and constitute a
27 premature attempt to litigate plan confirmation issues. CalPERS believes that the City is eligible for
28 relief under chapter 9 of the Bankruptcy Code. Stockton engaged in extensive pre-filing negotiations

1 with creditors holding a majority of the claims the City intends to impair in this bankruptcy case. The
2 City's negotiations took place over the course of 90 days and all parties in interest were provided
3 with the City's 790 page "Ask" that forms the basis for its eventual plan of adjustment. Furthermore,
4 the City only filed its bankruptcy petition in the face of extreme financial distress and after enacting
5 drastic cost-cutting measures over more than three years. The Capital Markets Creditors ignore the
6 plain language of section 109(c)(5)(B) to the extent that they insist that the City was required to
7 negotiate with CalPERS notwithstanding the City's intent to maintain its relationship with CalPERS.

8 **A. The City Has Complied with the "Good Faith" Requirement of Both Section**
9 **109(c)(5)(B) and Section 921(c) of the Bankruptcy Code.**

10 Distilled to its essence, the Capital Markets Creditors argument is that, as a matter of law, a
11 debtor cannot satisfy section 109(c)(5)(B)'s good faith requirement unless it attempts to negotiate an
12 impairment of all of its significant executory relationships prior to filing a chapter 9 petition, even
13 when that debtor does not intend to impair such parties in a plan of adjustment. *See, e.g.*, National
14 Supplemental Objection [Dkt. No. 635] at 1 ("As a matter of law, a debtor fails to negotiate in good
15 faith under section 109(c) when it shields its largest creditor while insisting the remaining similarly-
16 situated creditors compensate by carrying a disproportionate burden of impairment.") and Assured
17 Supplemental Objection [Dkt. No. 638] at 28 ("By failing to negotiate at all with CalPERS, the City
18 cannot claim to have negotiated in good faith for purposes of 11 U.S.C. § 109(c)(5)."). This
19 argument is contrary to the plain language of section 109(c)(5)(B) and represents a premature attempt
20 to contest whether the City's eventual plan of adjustment will unfairly discriminate against the
21 Capital Markets Creditors. Stockton satisfies the requirements of section 109(c)(5)(B) because the
22 City negotiated in good faith with those creditors it intended to impair based on the City's "Ask."

23 While the concept of "good faith" is not defined in the Bankruptcy Code, it is a fact-intensive
24 inquiry that must be based on context. The Capital Markets Creditors seek to apply a one-size-fits-all
25 approach to the good faith legal standard. That approach must be rejected. Once Stockton made the
26 business decision to retain the benefits of its continued relationship with CalPERS and participation
27 in the CalPERS system, it did not need to seek adjustments from CalPERS to reduce benefits because
28

1 nothing in the Bankruptcy Code requires that a municipality seeking protection under chapter 9, seek
2 to adjust the terms of significant executory relationships in order to be eligible.

3 *1. The Plain Language of Section 109(c)(5)(B) Requires Only That the City*
4 *Negotiate With Those Creditors It Intends to Impair.*

5 The Capital Markets Creditors' argument is that, by not seeking to impair CalPERS, the City
6 cannot, as a matter of law, satisfy the "good faith" requirement of section 109(c)(5)(B). This
7 argument must be rejected because it ignores the plain language of the Bankruptcy Code and because
8 it is not supported by the very cases upon which the Capital Markets Creditors rely. As shown
9 below, under the plain language of section 109(c)(5)(B), the City was not required, in its prepetition
10 negotiations, to seek impairment of each one of its creditors, no matter how large. Rather, the City
11 was only required to negotiate with a majority of each class of creditors that it intends to impair. Of
12 more relevance to the arguments raised here, section 109(c)(5)(B) does not require a municipality to
13 negotiate with parties to executory relationships which the municipality does not intend to impair.
14 Because the City engaged in good faith negotiations with a majority of the creditors it seeks to impair
15 under its "Ask," it has satisfied its burden under section 109(c)(5)(B) of the Bankruptcy Code.

16 It is a cardinal principle of statutory construction that the interpretation of a statute must
17 always begin with, and should most often end with, its text. *See, e.g., United States v. Ron Pair*
18 *Enters., Inc.*, 489 U.S. 235, 241 (1989) (noting that where a "statute's language is plain 'the sole
19 function of the courts is to enforce it according to its terms.'") (quoting *Caminetti v. United States*,
20 242 U.S. 470, 485 (1917)). In pertinent part, the Bankruptcy Code provides that an entity may be a
21 debtor under chapter 9 if the debtor, has among other things, "**negotiated in good faith with**
22 **creditors** and has failed to obtain the agreement of creditors holding at least a majority in amount of
23 the claims of each class **that such entity intends to impair under a plan** in a case under such
24 chapter[.]" 11 U.S.C. § 109(c)(5)(B) (emphasis added). The emphasized language demonstrates that
25 a debtor need only negotiate with those creditors it intends to impair under a plan. Prior to entering
26 into the AB 506 negotiations, the City made the business decision to retain its relationship with
27 CalPERS. Once that decision was made, the City was under no obligation under section
28 109(c)(5)(B)'s plain language to modify, impair, or even inquire about impairing, its ongoing

1 statutory obligations to CalPERS. The Capital Markets Creditors' reading of the statute is
2 nonsensical because it would require a financially distressed municipality to expend its scarce
3 resources negotiating an impairment of an obligation it wished to assume and could not readily
4 through negotiation. If Congress had intended that a debtor be required to seek concessions from
5 parties to executory relationships, it would have written such requirement into the Bankruptcy Code.
6 Instead, sections 109(c)(5)(A) & (B) refer only to a majority of the class of creditors which the debtor
7 seeks to impair. The plain terms of section 109(c)(5)(B) must govern the determination of the City's
8 good faith on this basis.

9 The Capital Markets Creditors' interpretation of section 109(c)(5)(B) is inconsistent with the
10 Ninth Circuit BAP's decision in *In re City of Vallejo*, 408 B.R. 280 (9th Cir. BAP 2009) ("*Vallejo*").
11 In *Vallejo*, the court considered whether under section 109(c)(5)(B), a municipality's good faith
12 negotiations with creditors must concern the possible terms of a plan of adjustment. In interpreting
13 that section, the court stated that the phrase "negotiated in good faith with creditors" must be given
14 meaning consistent with the remaining language in the statute. *Vallejo*, 408 B.R. at 296 (citing
15 *Marek v. Chesny*, 473 U.S. 1, 16 n.5 (1985) (Brennan, J., dissenting)). The BAP, in concluding that
16 the negotiations must revolve "around a proposed plan, at least in concept," stated the following:

17 The statute references adverse treatment ("impairment") to the interests of numerically
18 important creditors ("majority ... of each class") and specifically calls out creditors
19 holding at least a majority in the amount of claims of each class that a petitioner
20 intends to impair under a plan. . . . **In the end, the negotiations referred to in the
21 statute cannot be separated from its context, which clearly and unambiguously
22 refers to the treatment of impaired creditors under a plan.** The significance the
Code places on the lack of agreement with creditors identified by § 109(c)(5)(B)
bolsters our interpretation that the negotiations must cover their treatment under a
plan. **The creditors identified by § 109(c)(5)(B) are those necessary to confirm a
consensual plan of adjustment.**

23 *Vallejo*, 408 B.R. at 296-97 (emphasis added). Because the City made a business decision to assume
24 its relationship with CalPERS in its "Ask," the CalPERS' relationship would not be classified or
25 impaired under a plan. Accordingly, the City was not required to negotiate with CalPERS to become
26 eligible for chapter 9 relief. The statute, as the BAP stated, "clearly and unambiguously refers to the
27 treatment of impaired creditors under a plan." *Id.* It does not, as the Capital Markets Creditors would
28 suggest, refer to all creditors. See *In re Pleasant View Utility Dist.*, 24 B.R. 632, 639 (Bankr. M.D.

1 Tenn. 1982) (concluding that section 109(c)(5)(B) was met where evidence demonstrated that debtor
2 unsuccessfully negotiated in good faith with creditors who held more than 50% of the outstanding
3 bonds of the District). Because the City negotiated in good faith with the creditors holding at least a
4 majority in amount of the claims of each class that the City intended to impair under its plan, the City
5 is eligible for relief under the plain terms of section 109(c)(5)(B) and *Vallejo*. Any arguments to the
6 contrary must be rejected.

7 National argues at length in its initial objection to the City's eligibility that the City did not
8 meet the requirements of section 109(c)(5)(B) "because the City did not present a feasible plan that is
9 in the best interest of creditors in the AB 506 process negotiations." National Objection [Dkt. No.
10 477] ¶ 54. Nothing in the plain language of section 109(c)(5)(B) requires the City to establish that it
11 negotiated the terms of a plan that is feasible and in the best interests of creditors. These are
12 requirements for a court's confirmation of a plan of adjustment. *See* 11 U.S.C. § 943(b)(7) ("The
13 court shall confirm the plan if— . . . (7) the plan is in the best interests of creditors and is feasible.").
14 The Capital Markets Creditors put the cart before the horse by prematurely objecting to the
15 confirmation of a plan of adjustment based upon the City's "Ask." This is improper. All that is
16 required of the City to gain entry into the gates of chapter 9 is that it negotiated with the creditors it
17 intends to impair under a "proposed plan, at least in concept." *Vallejo*, 408 B.R. at 297 (also stating
18 that "a complete plan is not required," but rather "some outline or term sheet of a plan . . . is
19 necessary"). Even the court in *In re Sullivan County Regional Refuse Disposal District* ("*Sullivan*
20 *County*"), a case upon which both National and Assured place great reliance, stated that no "formal
21 plan" is required, but rather that a comprehensive workout plan is necessary to "avoid a too early and
22 rapid resort to the bankruptcy courts by municipalities." 165 B.R. 60, 78 (Bankr. D. N.H. 1994). Nor
23 does *In re Cottonwood Water & Sanitation District*, also cited by National, require the City to
24 establish that it presented and negotiated a formal plan that meets the requirements of section 943 to
25 creditors in negotiations prior to filing for bankruptcy. 138 B.R. 973, 979 (Bankr. D. Colo. 1992)
26 (stating that the debtor "must be prepared to show that it engaged in good faith negotiations with its
27 creditors concerning the **possible terms of a plan** to be effected pursuant to section 941") (emphasis
28 added). Thus, neither the Bankruptcy Code, nor the decisional authority cited by the Capital Markets

1 Creditors, require the City to establish that the plan that formed the basis of the City's negotiations
2 meet the confirmation requirements of section 943. If that were the case, than the separate
3 requirements of eligibility and plan confirmation would be merged at the beginning of the case. That
4 is not how Congress wrote the Bankruptcy Code nor can it be what Congress intended.

5 Lastly, the Capital Markets Creditors' interpretation of section 109(c)(5)(B) makes little sense
6 when one considers that a reduction of pension benefits administered by CalPERS for current and
7 former employees of the City would be impermissible under State law. *See, e.g.*, Cal. Gov. Code
8 § 20474 ("Any election made by amendment to the contract shall be irrevocable until the contract is
9 terminated. However, benefits provided by the amendment may be increased or improved from time
10 to time by further amendment to the contract."). It cannot be the case that the City is required to
11 negotiate with creditors it does not intend to impair and for which negotiations would be futile
12 because restructuring would be in violation of State law. Thus, the Capital Markets approach to good
13 faith must be rejected.

14 2. *The Cases Relied Upon by the Capital Markets Creditors are Easily*
15 *Distinguished.*

16 The Capital Markets Creditors primarily argue, based on *Sullivan County and In re Ellicott*
17 *School Building Authority*, 150 B.R. 261, 266 (Bankr. D. Colo. 1992) ("*Ellicott*"), that the City did
18 not negotiate in good faith because it "refus[ed] to negotiate an impairment to its single largest
19 liability." National Supplemental Objection [Dkt. No. 635] ¶ 12. First, as explained, even if
20 CalPERS were the City's largest creditor (which it is not) the Bankruptcy Code does not impose a
21 requirement upon the City to negotiate with CalPERS prepetition given that the City does not seek to
22 terminate its relationship with CalPERS under the terms of its "Ask." In addition, the cases relied
23 upon by the Capital Markets Creditors are distinguishable from this case and neither creates the
24 bright line rule that the Capital Markets Creditors advance.

25 In *Ellicott*, the court concluded that the debtor school authority did not meet the requirements
26 of 11 U.S.C. § 109(c)(5)(B) where it merely held three public meetings at which it "explained" its
27 proposed plan of adjustment but were advised that the "economic provisions" of the proposed plan
28 were not negotiable. *Ellicott*, 150 B.R. at 266. Stockton's negotiations were vastly more involved

1 than those which took place in *Ellicott*. Stockton’s negotiations took place pursuant to AB 506 over
2 the course of 90 days during which the City held numerous meetings with its creditors facilitated by a
3 distinguished mediator, presented financial and other information, and provided its 790-page “Ask”
4 to all interested parties. City of Stockton’s Memorandum in Support of Eligibility [Dkt. No. 19] at
5 18-19. The fact that the City proposed, based on a business decision, to maintain its relationship with
6 CalPERS does not negate the fact that it negotiated in good faith with those parties it may ultimately
7 seek to impair in a plan of adjustment. In *Ellicott*, the entirety of the Authority’s proposed plan was
8 not open to discussion. Here, the City willingly negotiated with a majority of the impaired creditors
9 of each class regarding the terms of the “Ask.” Such was not the case in *Ellicott*.

10 Likewise, *Sullivan County* is also distinguishable from this case. In *Sullivan County*, the court
11 ruled that the debtors failed to negotiate in good faith with regard to a plan where “at no time prior to
12 the Chapter 9 filing did the [debtors] set out . . . a comprehensive workout plan dealing with all of
13 their liabilities and all of their assets in terms comparable to a plan of adjustment that could be
14 effectuated under Chapter 9 of the Bankruptcy Code.” 165 B.R. at 78. The court also reasoned that a
15 party cannot negotiate in good faith where it ignores the contractual rights of the other party and
16 “refuses to acknowledge or throw into the negotiating equations a large and significant asset that it
17 holds.” *Id.* Here, the City provided a 790 page “Ask,” which will form the basis for its plan of
18 adjustment, to all parties in interest during the AB 506 process. Furthermore, the City did not ignore
19 a large asset of the estate, because CalPERS is not an “asset” of the City in the sense that the ability
20 to raise revenue through assessments was a significant asset in *Sullivan County*. *Id.* (“In the present
21 case, the most significant asset held by the Districts was the power to assess the member
22 municipalities for the unpaid service fees and thus in effect access the borrowing or taxing powers of
23 those municipalities to meet the debtor’s obligations.”). Indeed, National acknowledges this. *See*
24 National Objection [Dkt. No. 477] at 12 (“Similar to the debtor leaving out a major asset in the
25 negotiations in *Sullivan County*, the City intentionally left out its single largest unsecured liability
26 during the AB 506 process—its CalPERS liability.”).

27 Thus, the Capital Markets Creditors’ reliance on *Sullivan County* completely ignores the
28 context of that case. When one considers the context of Stockton’s prepetition negotiations, the

1 misplacement of the Capital Markets Creditors' reliance on *Sullivan County* becomes apparent. It
2 makes little sense for the Capital Markets Creditors to suggest that the City's sound business decision
3 to maintain its relationship with CalPERS in order to preserve benefits for the employees of City is
4 somehow equivalent to the City ignoring a large and significant asset in its pre-bankruptcy
5 negotiations with creditors regarding its intended plan. This is especially apparent given the City's
6 inability to unilaterally reduce its current and former employees' benefits because to do so would
7 violate State law. Placed in its proper context, *Sullivan County*, and the bright line rule the Capital
8 Markets Creditors try to extract from it, has no application to the facts of this case.

9 Finally, the Capital Markets Creditors and their experts make much of the fact that Stockton
10 did not apply for a hardship extension until December 2012 and suggest that this somehow evinces a
11 lack of good faith. Underlying this entire argument appears to be the assumption that such requests
12 are granted by CalPERS as a matter of course. As the City's case demonstrates, this is not so. Given
13 CalPERS' fiduciary obligations to the system as a whole, each hardship request must be reviewed on
14 an individual basis. Thus, the Capital Markets Creditors reliance on the timing of Stockton's request
15 as being an indicia of bad faith is specious because they can point to no facts that would establish that
16 the City would have qualified for the hardship extension prior to its filing for chapter 9 protection.

17 3. *The Capital Markets Creditors' Argument Rests on a Faulty Premise and is*
18 *Merely a Test-Run for Their Opposition to the City's Eventual Plan of*
Adjustment.

19 The Capital Markets Creditors argue that the Court should ignore the sound business decision
20 of the City not to seek further concessions affecting City employees. They state that CalPERS is the
21 "single largest liability" and construe the "Ask" as a take-it-or-leave it proposal. The Capital Markets
22 Creditors' assertion is based on the incorrect assumption that the "Unfunded Accrued Liability" that
23 CalPERS reflects in its Annual Valuation Reports is a current obligation of the City representing a
24 prepetition unsecured claim. The City may have had the same misperception at the time it filed its
25 bankruptcy petition. In its "List of Creditors Holding 20 Largest Unsecured Claims," [Dkt. No. 4],
26 Stockton listed CalPERS as its largest unsecured creditor and claims that it owes CalPERS \$147.5
27 million. This is incorrect. This amount, and the amounts cited by the Capital Markets Creditors, are
28 based on a fundamental misunderstanding of how the CalPERS systems works and what the term

1 “Unfunded Accrued Liability” means. In fact, even though the Capital Markets Creditors have
2 already deposited CalPERS’ Deputy Chief Actuary, and are therefore aware of the fact that this
3 number does not represent what Stockton actually owed CalPERS as of the date of the City’s filing,
4 they repeatedly cite this figure (or more recent figures) as the cornerstone of their “lack of good faith”
5 argument. As explained above, as of the date of its filing Stockton did not owe, nor did it have an
6 obligation to pay, CalPERS \$147.5 million. Rather, according to the most recent Annual Valuation
7 Reports, the City must pay CalPERS approximately \$29.5 million during the 2012-13 fiscal year in
8 order to remain current on its payments to CalPERS. *See* Exhibits 422 at 5 & 423 at 5 (“Total
9 Employer Contribution” line item). The City has a continuing obligation to comply with State law
10 with respect to its participation in CalPERS to include funding its ongoing payment obligations.
11 Should the City fail to fulfill its payment obligations to CalPERS during the course of the chapter 9
12 case, CalPERS would hold an administrative claim for any unpaid obligations and other statutorily
13 required amounts to be paid under the PERL, which claim would have to be paid in full in order for a
14 plan to go effective. 11 U.S.C. § 943(b)(5).

15 Once the faulty premise regarding the nature of CalPERS’ relationship with the City is
16 clarified, the true purpose of the Capital Markets Creditors’ arguments on bad faith is obvious. The
17 Capital Markets Creditors are using this costly and protracted eligibility litigation to (1) extract
18 financial pain from the City in order to force the City to reconsider its decision to remain in the
19 CalPERS system; and (2) to preview arguments that they intend to make when the City proposes its
20 plan of adjustment. For example, the concept of “unfair discrimination” or variants on the same
21 theme, permeate the arguments made by both National and Assured. *See, e.g.*, National
22 Supplemental Objection [Dkt. No. 635] ¶ 2 (claiming “disproportionate burden of impairment”), ¶ 4
23 (“the City entered bankruptcy intending to spread losses disproportionately among a subset of
24 creditors”), ¶ 9 (“City’s unstinting efforts to shelter CalPERS as the expense of its bondholders”);
25 ¶ 12 (“If the City has its way, the remaining creditors will be forced to fight over a radically reduced
26 pool[.]”) & ¶ 38 (“[T]he City never intended, and still does not intend, to seek to impair its largest
27
28

1 unsecured creditor, CalPERS.”);¹⁷ *see also* Assured Supplemental Objection [Dkt. No. 638] at 3
 2 (claiming lack of negotiations with CalPERS “target[s]” the Capital Markets Creditors). Indeed, the
 3 disingenuous nature of the Capital Markets Creditors objections and their strident requests for
 4 dismissal is on full display when one considers the statements made by counsel at the Court’s recent
 5 hearing on the Rule 9019 Motion. For example, Franklin’s counsel noted that dismissing the City’s
 6 chapter 9 petition “is in no one’s interest. Everyone gets hurt then. The City gets hurt. Creditors get
 7 hurt. That’s in no one’s interest.” *See* Lubic Decl., Exhibit 1 at 75 (9019 Hearing) Likewise,
 8 National’s counsel proclaimed “Lord help us” if the case was dismissed and had to be re-filed. *Id.* at
 9 89. These statements by counsel, in open court, demonstrate the real motives behind the Capital
 10 Markets Creditors in opposing the City’s eligibility.

11 4. *The City Meets the “Good Faith” Requirement of Section 921(c).*

12 The Capital Markets Creditors complain that because the City intends to impair their claims
 13 under their “Ask”—stating that this is the sole purpose of the filing—that the City filed its petition in
 14 “bad faith.” The City’s filing of the petition was not an abuse of the bankruptcy process and the fact
 15 that the Capital Markets Creditors claims may be impaired, while the City assumes its executory
 16 relationship with CalPERS, does not compel a conclusion that the petition was filed in bad faith.

17 Although the term “good faith” is not defined in the Bankruptcy Code, the requirement
 18 provides “a useful means for the Court to preserve the protection of the Code for those for which it
 19 was actually intended.” *Sullivan County*, 165 B.R. at 80 (citations omitted). In ascertaining the
 20 meaning of this phrase, the court in *Sullivan County* exhaustively reviewed case law under previous
 21

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 23
 24 ¹⁷ In addition, National spends a significant portion of its brief addressing extraneous matters. To
 25 wit: That the City cannot claim that negotiations with CalPERS were “impracticable,” within the
 26 meaning of section 109(c)(5)(C) because CalPERS can be impaired under chapter 9 without violating
 27 section 903 or the Tenth Amendment to the United States Constitution. National Supplemental
 28 Objection [Dkt. 635] at 16-19. This Court should not prematurely address arguments about whether
 Stockton’s obligations to CalPERS can, consistent with section 903 or the Tenth Amendment, be
 impaired in this chapter 9 case. In support of eligibility, Stockton has not argued that negotiations
 with CalPERS were “impracticable” because its obligations to CalPERS cannot be impaired in
 bankruptcy. If these issues are presented in connection with the proposal of the City’s plan of
 adjustment, the Court can address them at that time.

1 versions of the Bankruptcy Act to determine what constitutes “good faith.” *Id.*, at 80-82. In sum, the
2 court summarized the requirement as follows:

3 In the Chapter 11 context, ‘good faith’ has been described as a requirement which
4 prevents abuse of the bankruptcy process by debtors whose overriding motive is
5 to delay creditors without benefitting them in any way or to achieve reprehensible
6 purposes. Determining whether a petition has been filed in good faith requires an
7 evaluation of a debtor’s financial condition, motives, and the local financial
8 realities. These comments would appear to be equally applicable, at least in part,
9 to a Chapter 9 petition.

10 *Id.*, at 82. (quotations and citations omitted). Thus, under *Sullivan County*, a case upon which the
11 Capital Markets Creditors heavily rely, the City can only be found to have filed its petition in bad
12 faith (*i.e.*, not in good faith) if this Court concludes that the City’s “overriding motive is to delay
13 creditors” or that it seeks “to achieve reprehensible purposes.” Nothing in the Capital Markets
14 Creditors arguments support such findings. The City has not filed its petition to harass or delay
15 creditors, nor has it done so for reprehensible purposes. Instead, the City, after exhausting all other
16 options, including the imposition of serious cost-cutting measures, formulated a detailed “Ask” and
17 only after its 90-day negotiation efforts failed did it file its petition. The City’s prepetition conduct
18 demonstrates exactly what a financially distressed municipality should do before it makes the
19 decision to file for protection under chapter 9. The City’s actions are in no way an abuse of the
20 bankruptcy process; instead, the City’s actions are consistent with the very purpose of the Bankruptcy
21 Code. *See In re Villages at Castle Rock Metro. Dist. No. 4*, 145 B.R. 76, 81 (Bankr. D. Colo. 1990)
(concluding that the district’s chapter 9 petition was filed in good faith where the debtor was
22 financially distressed, lacked funds to make its next scheduled payment to bondholders, and had been
23 attempting for some time to achieve a restructuring of its debt and filed its petition to do so).

24 The Capital Markets Creditors’ argument that the City filed its petition in bad faith under
25 section 921(c) because it failed to negotiate for an impairment of CalPERS is no more meritorious
26 than their arguments that the City failed to negotiate in good faith under section 109(c)(5)(B). Unlike
27 the debtor in *Sullivan County*, the City’s decision to file its bankruptcy petition took place after the
28 City underwent significant efforts to avoid bankruptcy and was “the end result of considered debate,
weighing the benefits and consequences of the petition.” 165 B.R. at 82. The City’s Memorandum
in Support of Eligibility extensively catalogs all of the efforts the City undertook in an effort to

1 reduce costs and expenses in the hopes of avoiding having to file a chapter 9 petition. *See generally*
2 City of Stockton's Memorandum in Support of Eligibility [Dkt. No. 19] at 3-17.

3 Despite these efforts, Assured boldly asserts that "the City's entire purpose in filing this case
4 has been to force Assured and the other Capital Markets Creditors to pay for otherwise-unfunded
5 benefits to labor-including CalPERS' ever-increasing pension benefits costs." Assured Supplemental
6 Objection [Dkt. No. 638] at 34. National is no less timid, stating that "[a]ll of this is evidence of the
7 City's primary goal in its bankruptcy filing, which is to maintain the bloated CalPERS pensions doled
8 out to City employees (including members of the SDT) in richer times and have its remaining
9 creditors, including National, foot the bill." National Supplemental Objection [Dkt. No. 635] at 15.
10 These claims ignore reality because they turn a blind eye to all of the things the City did to cut wages
11 and benefits prior to filing for chapter 9 protection and instead focus their sites solely on the City's
12 business decision to remain within the CalPERS system. Moreover, they also ignore the fact that the
13 City's first order of business on entering into chapter 9 was to unilaterally cut its retirees' health
14 benefits and that the City has negotiated for other significant compensation concessions from labor
15 before and after the filing of the case. That the City chose to maintain its relationship with CalPERS
16 under its "Ask" is not evidence that the City filed its petition in bad faith—especially in light of the
17 significant reductions to employee compensation and benefits that have been made to date and which
18 are proposed under the "Ask," and given that a reduction of pension benefits administered by
19 CalPERS for current and former employees of the City would violate State law. *See, e.g., In re*
20 *Chilhowee R-IV School Dist.*, 145 B.R. 981, 983 (W.D. Mo. 1992) (overruling objections to debtor's
21 chapter 9 petition and stating "to say that [the school board] had to institute the highest possible levy
22 (requiring state approval) before taking any other action or be guilty of bad faith filing, is
23 unrealistic."); *see also In re McCurtain Mun. Auth.*, 2007 WL 4287604, *6 (Bankr. E.D. Okla. 2007)
24 (failure to generate revenues by assessing citizens does not necessarily indicate bad faith where water
25 and sewer rates in the city were higher than surrounding areas and where unlikely that sufficient
26 funds could be generated by assessment or imposition of higher rates).

27 The City's decision to file was the result of the serious financial realities faced by the City and
28 was made only after the City undertook serious measures over the course of the last three years with

1 the purpose of avoiding having to file for protection under chapter 9. To suggest that the City's
2 "entire purpose" or "primary goal" of filing for chapter 9 protection was to require the Capital
3 Markets Creditors' to "foot the bill" for the benefits CalPERS' provides is completely divorced from
4 reality. For these reasons, dismissal of the case is not warranted under section 921(c).

5 **B. There is Nothing Unfair About Stockton Exercising Its Business Judgment and**
6 **Retaining Its Relationship With CalPERS.**

7 A consistent theme throughout the Capital Markets Creditors' objections is that the City's
8 business decision to maintain its relationship with CalPERS is somehow unfair. While this argument
9 has nothing to do with whether the City is eligible for protection under chapter 9, put simply, there is
10 nothing unfair about the City's desire to retain its relationship with CalPERS.

11 First, two of the most vocal Capital Markets Creditors—Assured and National—assumed the
12 risk of their financial responsibilities by choosing to insure the bonds at issue in this case.
13 Presumably both Assured and National performed appropriate due diligence prior to insuring the
14 bonds, including diligence regarding the City's pension obligations and relationship with CalPERS.
15 Presumably both were paid significant premiums for their assumption of those risks. Indeed, the
16 entire purpose of both Assured's and National's business relationship with Stockton was to insure
17 Stockton's bonds in the event of non-payment. Now that Assured and National are being asked to
18 honor their commitments, they seek to impose additional financial burdens on Stockton's employees'
19 through a reduction of past and present pension benefits—benefits that those individuals earned and
20 earn by showing up to work each day. If anything is unfair, it is Assured's and National's attempt to
21 shift to Stockton's employees and retirees the risks that these insurers were paid to assume.

22 Second, despite the Capital Markets Creditors' rhetoric to the contrary, CalPERS stands on
23 much different footing than the Capital Markets Creditors. Unlike the Capital Markets Creditors,
24 CalPERS is not a purveyor of exotic financial instruments and insurance for profit. In fact, CalPERS
25 sells nothing and makes no profit from the contributions it receives from its members and their
26 employers. Any gains CalPERS realizes in the market go to pay benefits to individuals who have
27 worked (some for a lifetime) to earn those benefits. CalPERS is a not-for-profit entity. The Capital
28 Markets Creditors business purpose is to profit for their shareholders and investors through the

1 acceptance of financial risk. The Capital Markets Creditors' claim that the entire purpose of
2 Stockton's bankruptcy filing was to force the bondholders and those insuring those bonds to pay for
3 Stockton's unfunded pension benefits is simple hyperbole. Put simply, Stockton has already slashed
4 and cut its current and former employees' salaries and it is not unfair for the City to continue to
5 administer its public employee benefits through CalPERS.

6 **IV. CONCLUSION**

7 For the reasons stated above, and those provided by the City, CalPERS respectfully requests
8 that this Court (1) overrule the objections of the Capital Markets Creditors; (2) determine that the
9 City of Stockton is eligible for protection under the chapter 9; and (3) enter an order of relief.

10 Respectfully submitted,

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16 Dated: February 15, 2013

17 By: /s/ Michael B. Lubic
18 Michael B. Lubic

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