California Retirement System Loses Big in Stockton Bankruptcy Ruling

On Tuesday, U.S. Bankruptcy Judge Christopher Klein surprised nearly everyone with his ruling that Stockton could [cancel its contract](#) with the California Public Employees Retirement System (CalPERS) as part of its plan for reorganization after filing for Chapter 9 bankruptcy two years ago. CalPERS immediately issued a statement claiming that Klein's decision was not legally binding:

> This ruling is not legally binding on any of the parties in the Stockton case or as precedent in any other bankruptcy proceeding and is unnecessary to the decision on confirmation of the city of Stockton's plan of [reorganization].

CalPERS is certainly hoping so. It manages $300 billion of funds for municipal employees across the state and has been spearheading a drive to negate a similar decision by a bankruptcy judge in the Detroit bankruptcy case. These two similar rulings could open the door for other cities teetering on the edge of bankruptcy and seeking a way to regain solvency after making excessively generous pension and healthcare promises in the run-up prior to the Great Recession.

Stockton is the poster child for those "excessively generous" promises. Between 1998 and 2005, prices of real estate in Stockton, about 75 miles from Sacramento, tripled. As a result, revenues from builder fees and sales and property taxes soared, and the Stockton City Council took advantage. They offered what some called "Lamborghini" benefits for its city workers, claiming that they were necessary to attract the talent needed. For example, if someone worked for the city for just one month, he and his spouse became eligible for retirement healthcare benefits *for life*.

The city borrowed and spent and then borrowed some more, albeit some of the $35 million the city borrowed helped pay for fire stations, a police station, bridges, street improvements, and parks. One of the entities it borrowed from was the mutual fund giant Franklin Templeton. When Stockton offered Franklin Templeton just $350,000 to settle that debt as part of its bankruptcy reorganization plan, while leaving the city's obligations to CalPERS intact, Templeton filed suit. In essence, it claimed that CalPERS should be treated as any other common creditor and not given special dispensation just because a state law allegedly protects it from federal bankruptcy rules.

Klein not only ruled that Stockton was free, under those federal bankruptcy rules, to change or terminate its contract with CalPERS, it also could avoid the $1.6 billion "termination fee" that CalPERS threatened to enforce through a lien on city assets. Said Klein: "Why should I take that lien seriously? I may avoid it as a black-letter matter of [federal] bankruptcy law. The bankruptcy code provides that the lien can be avoided and be treated as an unsecured claim."

When lawyers for CalPERS claimed that terminating their contract with Stockton would cause many of Stockton's employees to quit and move elsewhere in order to be covered under CalPERS, Klein disagreed. He said that Stockton has many other options than CalPERS to provide those benefits to its employees, like an insurance company or another multiemployer pension plan or one of California's county-run pension plans. Or, in the gravest extreme, Stockton would be free, under its reorganization plan, to cancel its retirement plan obligations altogether.

Klein put off a final decision on ruling whether Stockton's reorganization plan was sufficient to allow it to exit bankruptcy until next month. But it was good news for municipal bond holders who have been watching the Stockton case with great interest, concerned about how their interests would be protected as other failing municipalities try to maneuver their way out from under excessively generous promises and loans made during the good times.

One of CalPERS attorneys, Harvey Leiderman, warned that Klein's ruling now gave other cities an "off ramp on the highway" any time they couldn't keep their promises to their employees. He also claimed weakly that "giving municipalities the option to walk away from their statutory obligations to fund the promised benefits means they will never be able to offer services to the public."

What Klein's ruling really means, however, is that public pension plans are no longer sacrosanct and protected when a city is forced to declare bankruptcy, that they must stand in line with all the other creditors as the reorganization plans are developed. It confirms Franklin's contention that those public pension plans should not escape the bankruptcy intact while other creditors such as themselves are forced to take drastic haircuts.

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