
Stockton's case will soon be over but California's pension problem will not
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Most of Stockton's confirmation hearing, which ended on 5 June, focused on the value of the collateral of Franklin Templeton Investments, the city's only dissenting creditor. But the question that is most important from a public policy perspective is whether Stockton can exit Chapter 9 bankruptcy without impairing pensions, agreed two policy experts.

In the aftermath of Stockton's confirmation hearing, pensions remain the biggest conundrum in California's public policy, said Bill Whalen, research fellow at the Hoover Institution, a public policy research center at Stanford University.

A budget vote is coming up in Sacramento and Governor Jerry Brown has made it a top priority for the state to deal with one aspect of the pension predicament, the California School Teachers Retirement System (CalSTRS) USD 74bn unfunded liability, Whalen said.

But it would take a city larger than Stockton, San Bernardino or Vallejo to go into a genuine pension crisis for California to deal with the California Public Employees Retirement System (CalPERS) issue on a state level, Whalen added.

The main difference between CalPERS and CalSTRS is that the former has the authority to raise its own contribution rates. Instead, CalSTRS requires new legislation by the legislature and the governor, as previously reported.

Also, the CalSTRS issue affects the state more directly, as opposed to local municipalities, because the "bill" for CalSTRS funding will eventually come back to the state through its education budget, as previously reported. Even though school districts will be required to pay 71% of the CalSTRS contribution increases, the funds will likely come from their Proposition 98 funding, a constitutional calculation formula, which requires the state to allocate a minimum percentage of its budget to education funding.

The Pension Reform Act was a statewide ballot championed by a group of California mayors which aimed to amend the state's constitution to allow for future pension benefits impairment, as previously reported. It aimed to give municipalities the authority to negotiate changes to existing employees' pension or retiree healthcare benefits on a strictly going-forward basis, but will not appear on the November 2014 ballot.

Over the last five years, lawmakers in California have gone from completely ignoring the pension problem to acknowledging that it represents a long-term obligation crisis statewide; but they are still not ready to face it head on, Whalen said.

Change begins at the grass-roots

Negotiations between the city of San Bernardino and CalPERS, its largest impaired creditor, have been going on since 29 August 2013, when Judge Meredith Jury granted the city bankruptcy protection under Chapter 9, after a year-long eligibility battle.

Although mediation is taking longer than expected, creditors cannot move forward with a competitive plan of debt adjustment (PDA) in a Chapter 9, as they can do in a Chapter 11, said Michael Sweet, a Fox Rothschild partner and bankruptcy attorney who is following the case closely.

The latest developments in Stockton's case, especially regarding the "feasibility test" of Stockton's PDA, might affect the San Bernardino mediation, Sweet said.

The "feasibility test" essentially means that the city needs to convince the judge that it is possible to put together a feasible plan of economic recovery without impairing CalPERS, its largest creditor, as previously reported.

Ever since March, Judge Klein has said that if Stockton cannot perform sustainably in accordance with its PDA, there could be a possible "Chapter 18" bankruptcy, namely subsequent Chapter 9 bankruptcies. During a 19 March status hearing he said that Stockton could end up like the city of Vallejo, where a structural deficit remains post-bankruptcy because the city did not modify its pensions.

To the extent that CalPERS thinks that Judge Jury will have the same view as Judge Klein, it is possible that CalPERS will work harder to get to a place where there is a consensual PDA for San Bernardino's bankruptcy, which might include certain aspects of CalPERS' impairment, Sweet said.

Growing case law

An interesting trend that emerges from cases like Stockton and Detroit is that the focus is shifting from just "getting a deal" with creditors to putting together a feasible and sustainable plan for an exit from bankruptcy, said Bill Glasgall, state and local program director for the Volcker Alliance.

This is evident in Detroit, where Judge Rhodes appointed an independent advisor to assess the feasibility of the plan; and it is also evident in Stockton, where Judge Klein brought up the pensions issue, even though the city did not impair CalPERS, Glasgall said.

Default is always a fairly remote possibility in the municipal sector; and even the few Chapter 9 municipal bankruptcies have not been in most cases about true municipalities but rather hospitals and other municipal issuers, Glasgall said.

So this makes the developments in the few city bankruptcies currently adjudicated, such as Stockton and Detroit, crucial for the development of Chapter 9 case law, Glasgall said.

Apart from legal developments, Stockton's case teaches California important public policy questions, Whalen said.

"When you look at cities like Stockton and San Bernardino and ask 'how did they get there?' you see the same elements: demanding unions and lawmakers that were too eager to make concessions and turned a blind eye on pensions," Whalen said.

"We keep getting reports that Stockton's housing market is improving and that San Bernardino's unemployment rate is declining. These are signs of improvements. But are those initial elements that created the problem eliminated? The answer is 'no'," Whalen said.

As long as there is no state-wide effort to address the pension issue, crises will continue to arise on a city-by-city or county-by-county basis, Whalen said.

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