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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re:	Case No. 12-32118
CITY OF STOCKTON, CALIFORNIA,	D.C. No. JD-2
Debtor.	Chapter 9
	FRANKLIN'S MOTION TO ALTER AND AMEND FINDINGS OF FACT AND CONCLUSIONS OF LAW REGARDING ALLOWED AMOUNT OF RETIREE HEALTH BENEFIT CLAIMS
	Hearing: December 10, 2014 Time: 11:00 a.m. Dept: C, Courtroom 35 Judge: Hon. Christopher M. Klein

Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund (collectively, "Franklin") hereby move the Court pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure to alter and amend its findings of fact and confusions of law, as stated on the record at the hearing held on October 30, 2014 (the "Hearing"), to revise the aggregate allowed amount of Retiree Health Benefit Claims to $261.9 million – the amount reflected in the City's audited financial statements as of the Petition Date – in lieu of the $545 million amount adopted by the Court.[1]

INTRODUCTION

Franklin objected to the $545 million amount of Retiree Health Benefit Claims to which the City had stipulated during the bankruptcy case,[2] and Franklin presented evidence at trial that the City's actual liability was approximately $261.9 million – the amount reflected in the City's audited financial statements as of the Petition Date. Counsel for the City has confirmed that the issue was "fully and well-briefed by the parties[.]"[3]

At the Hearing, the Court read into the record its findings of fact and conclusions of law regarding confirmation of the Plan. The Court then inquired, "did I miss anything? Are there supplementary findings I should make?"[4] Franklin's counsel responded by asking whether the Court had "made a finding of the amount of the Retirees' healthcare claims as of the petition date?"[5]

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[1] Capitalized terms not defined in this Motion have the meanings given to them in the *First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California, As Modified (August 8, 2014)* [DN 1645] (the "Plan"). Relevant portions of the transcript of the Hearing ("Tr.") (Exhibit A), and other evidence cited in this Motion, are attached as Exhibits.

[2] *Franklin's Summary Confirmation Objection* [DN 1273] at 60-63; *Franklin's Supplemental Confirmation Objection* [DN 1377] at 40-44; *Franklin's Post-Trial Brief* [DN 1689] at 40 n.121.

[3] Tr. at 46:17.

[4] Tr. 41:16-17.

[5] Tr. 43:25-44:2.

Without taking argument, the Court then made a "determination" that the aggregate allowed amount of the Retiree Health Benefit Claims was $545 million.[6] The Court, however, stated that the ruling was "fair game for a Rule 52(b) Motion to try to get me to adjust that number. So I'll take a harder look at it, full and fair harder look at that question if an appropriate motion is made."[7]

Franklin now submits that motion and requests that the Court amend its ruling to adjust the allowed amount of Retiree Health Benefit Claims to the discounted present value of $261.9 million. As shown below, that adjustment will have absolutely no impact on retirees, whose treatment and distributions under the Plan will remain unchanged, but will more than double the minuscule sub-1% payment to be made under the Plan in respect of Franklin's unsecured claim.

ARGUMENT

A. Rule 52(b) Authorizes The Court To Change The Allowed Amount Of Retiree Health Benefit Claims To $261.9 Million.

Rule 52(b) of the Federal Rules of Civil Procedure, applicable here pursuant to Rules 7052 and 9014 of the Federal Rules of Bankruptcy Procedure, provides that "[o]n a party's motion . . . , the court may amend its findings – or make additional findings – and may amend the judgment accordingly." Fed. R. Civ. P. 52(b).

Amendment under Rule 52(b) is warranted where a court fails to "make findings of fact germane to" an issue raised by the parties, *In re Perotti*, No. 1:07-bk-01889MDF, 2008 Bankr. LEXIS 4629, at *3 (Bankr. M.D. Pa. Oct. 22, 2008), and otherwise to "correct . . . an obvious oversight." *In re Kora & Williams Corp.*, No. 88-41402PM, 2007 Bankr. LEXIS 1283, at *3 (Bankr. D. Md. Feb. 2, 2007); *see also Ne. Drilling, Inc. v. Inner Space Servs.*, 243 F.3d 25, 35 (1st Cir. 2001) ("Rule 52(b) . . . allows a court that has recently tried the case, rather than an appellate tribunal perusing a cold record, to determine the propriety of considering those additional facts."); *Dow Chem. Co. v. United States*, 278 F. Supp. 2d 844, 847 (E.D. Mich. 2003) ("Relief under [Rule 52(b)] is appropriate in cases of manifest factual error, if newly discovered evidence is

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[6] Tr. 47:22.

[7] Tr. 47:22-25; *see id.* at 54:4-5 ("I'm sticking with the $545 million for the Retirees") and 54:10-12 ("[A]t least for 14 days, you get to revisit anything. You haven't given up anything.").

available, or where further action by the Court would clarify the record for appeal."), *overruled on unrelated grounds*, *Dow Chemical Co. v. United States*, 435 F.3d 594 (6th Cir. 2006).

Here, the Court did not make any findings of fact to support its conclusion that the Retiree Health Benefit Claims should be allowed in a total amount of $545 million, and the Court did not discuss any aspect of the evidence presented or the parties' substantial briefing as to the issue. Instead, the Court simply adopted the number mentioned by the City, but indicated that it would "take a harder look at it" if Franklin submitted "a Rule 52(b) Motion to try to get me to adjust that number."[8]

For the reasons set forth below, the Court overlooked material evidence and authority requiring that the Retiree Health Benefit Claims be discounted to present value. Accordingly, Rule 52(b) authorizes the Court to revisit the issue at this time.

B. The City Improperly Inflated The Amount Of The Retiree Health Benefit Claims To Franklin's Detriment.

Pursuant to the Retirees Settlement, the City agreed to allow the Retiree Health Benefit Claims in an aggregate amount of $545 million.[9] The stipulated amount consists of the estimated payments that the City would make to procure health benefits over the expected lifespan of each of the 1,100 retirees (and their respective dependent or spouse, if any) with a Retiree Health Benefit Claim.[10] It is simply the sum total of payments that the City might have had to make over the next forty years or more, without discounting to present value those estimated future payments in any way.[11]

The individual claim amounts to which the City has stipulated are staggering. The average listed Retiree Health Benefit Claim amount for each of the 1,100 retirees is nearly $500,000. There

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[8] Tr. 47:23-24.

[9] 5/13/14 Tr. at 144:9-25 (Goodrich) (Exhibit B).

[10] *Id*. at 145:19-146:21 (Goodrich).

[11] *Id*. at 147:2-148:1 (Goodrich).

are 131 retirees with listed claims over $750,000, and an unbelievable 67 with listed claims of more than $1 million.[12]

As those figures illustrate, the City's calculation vastly overstates the actual amount of the City's liability. As shown below, the net present value of the City's liability for retiree health benefits as of the Petition Date was approximately $261.9 million, less than half of the amount to which the City stipulated.

This inflated calculation directly impacts Franklin. Under the Plan, Franklin's unsecured claim is classified into Class 12. Class 12 claims are to receive a payment equal to the "Unsecured Claim Payout Percentage," which is defined as a percentage "equal to the percentage paid on account of the Retiree Health Benefit Claims."[13] The Plan specifies that, "unless the amount of the Retiree Health Benefit Claims changes, that percentage will be equal to 0.93578%, *i.e.*, $5,100,000 divided by $545,000,000."[14]

Under this formula, the higher the amount of the Retiree Health Benefit Claims the lower the payment to Franklin. Because the City had agreed to pay a fixed amount in respect of the Retiree Health Benefit Claims regardless of their allowed amount,[15] the City was incentivized to inflate the amount of Retiree Health Benefit Claims in order to reduce the "Unsecured Claim Payout Percentage" and thus minimize its payment to Franklin on account of its unsecured claim under the Plan.

As shown below, that is exactly what the City did. Had the City used the discounted present value of the Retiree Health Benefit Claims set forth in its financial statements – which would have

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[12] *See Amended List Of Creditors And Claims Pursuant To 11 U.S.C. §§ 924 And 925 (Retiree Health Benefit Claims)* [DN 1150] (Exhibit C).

[13] Plan §§ I.A.198, IV.M.2 (Exhibit D).

[14] Plan § I.A.198.

[15] The Retirees Settlement provides for the City to pay $5.1 million in respect of Retiree Health Benefit Claims regardless of the size of the allowed amount of the claims. 5/13/14 Tr. at 152:12-153:5 (Goodrich). The Retirees Committee conceded that "the City doesn't care whether or not [the allowed amount] is higher or lower" because the payment amount is fixed, and that "[t]here was not a relationship between the [$]5.1 million and the [$]546 million, now or ever." Trial Ex. 2632 (Deposition Designation of Dwayne Milnes) at Tr. 61:21-23 and 75:17-18 (Exhibit E).

had no impact whatsoever on the fixed distributions it promised to make to retirees – the "Unsecured Claim Payout Percentage" under the Plan would have been 1.94731% ($5,100,000 divided by $261,900,000). That minuscule amount apparently was not low enough, however, so the City then inflated the Retiree Health Benefit Claims to $545 million and thus reduced Franklin's payment percentage to 0.93578%.

In doing so, the City contradicted its historical practice, violated governing accounting rules, and ignored the requirements of the Bankruptcy Code.

1. The City Historically Discounted To Present Value Its Liability For Retiree Health Benefit Claims.

The City's calculation of the Retiree Health Benefit Claims directly conflicts with the way that the City reported its liability for retiree health benefits in its audited financial statements. At all times, those statements reflected the discounted present value of the liability, not the sum total of all future amounts the City projected it might have to pay to satisfy its obligations. Notably, the City's audited financial statements as of the Petition Date indicate that the City's liability for retiree health benefits was $261.9 million,[16] less than half the $545 million Petition Date liability to which the City stipulated during the bankruptcy case.

The City's practice of discounting future liabilities to present value was not unusual or anomalous. The Governmental Standards Accounting Board requires that a municipality's liability for retiree health benefits be discounted to present value in its financial statements.[17] Franklin's expert explained why that requirement makes sense from an economic perspective:

> Standard practice entails calculating the *present value* of future benefits based on forecasts of the actual benefits to be provided using standard actuarial data and assumptions regarding the costs of providing health care. This is precisely what Segal itself did in the actuarial valuation reports used to calculate the City's retiree

[16] Trial Ex. 2064 (City of Stockton 2011-12 Comprehensive Annual Financial Report) at CTY225552-54 (Exhibit F); 5/13/14 Tr. Tr. at 148:2-149:12 (Goodrich); Trial Ex. 2640 (Deposition Designation of Teresia Zadroga-Haase) at 36:7-24 (Exhibit G).

[17] *See* Trial Ex. 2614 (Governmental Accounting Standards Board Statement No. 45 (Accounting And Financial Reporting By Employers For Postemployment Benefits Other Than Pensions)) (Exhibit H); Trial Ex. 2967 (Moore Report) at 15 (Exhibit I).

> health care liability for purposes of the City's audited financial statements (as described in more detail below). There is no basis for the abrupt and unexplained change in methodology in the bankruptcy case.
>
> [I]t makes no sense simply to tally up projected future health care expenses payable over the next thirty years or more. The payment of a claim thirty years from now obviously is less of a burden than the payment of the same claim today. This is why generally accepted accounting principles dictate that future liabilities like retiree health care benefit costs be discounted to present value in order to provide an accurate representation of the liability in an entity's financial statements.[18]

Notably, the City's designated witnesses could not provide any credible explanation regarding why the City abandoned its pre-bankruptcy practice of discounting retiree health benefit liabilities to present value.[19] The evidence is clear that the City did so for one only reason – to reduce its payment obligations on Franklin's unsecured claim by more than half.

2. The Bankruptcy Code Requires That Retiree Health Benefit Claims Be Discounted to Present Value.

In addition to running afoul of past practice and governing accounting rules, the City's failure to discount the Retiree Health Benefit Claims to present value renders them disallowable under section 502(b) of the Bankruptcy Code.

Section 502(b) requires that the Court "determine the amount of [alleged] claim[s] in lawful currency of the United States as of the date of the filing of the petition." 11 U.S.C. § 502(b). Per section 502(b), "[t]o insure the relative equality of payment between claims that mature in the future and claims that can be paid on the date of bankruptcy, the Bankruptcy Code mandates that all claims for future payment must be reduced to present value." *In re CF&I Fabricators of Utah, Inc.*, 150 F.3d 1293, 1300 (10th Cir. 1998) (emphasis added) (citing section 502(b)). "Discounting is consistent with the fundamental goal of treating similar claims in the same manner, and reflects the economic reality that a sum of money received today is worth more than the same amount received

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[18] Trial Ex. 2967 (Moore Report) at 16 (emphasis in original); *see also* 5/14/14 Tr. at 63:25-70:1 (Moore) (Exhibit J).

[19] 5/13/14 Tr. at 149:13-152:3 (Goodrich); Trial Ex. 2640 (Deposition Designation of Teresia Zadroga-Haase) at 36:25-37:16.

tomorrow." *In re Trace Int'l Holdings*, 284 B.R. 32, 38 (Bankr. S.D.N.Y. 2002) (emphasis added) (citations omitted).

Courts therefore routinely discount claims for future employment-related benefits to present value as of the bankruptcy petition date, including claims for unfunded pension liabilities and for deferred compensation. *See, e.g., In re CSC Indus.*, 232 F.3d 505, 508 (6th Cir. 2000) ("the bankruptcy court must value present claims and reduce claims for future payment [of pension benefits] to present value, while also keeping in mind that a fundamental objective of the Bankruptcy Code is to treat similarly situated creditors equally"); *CF&I*, 150 F.3d at 1300 ("Inasmuch as those [pension] liabilities are for beneficiaries' payments that extend into the future, the amount of the liability must be reduced to present value so the debt can be dealt with under the reorganization plan."); *Kucin v. Devan*, 251 B.R. 269, 273 (D. Md. 2000) (claims for deferred compensation properly discounted to present value as of the petition date); *Trace*, 284 B.R. at 38 ("Absent bankruptcy, a creditor like Nelson would have to wait many years before receiving and using the entire payout. Paying the face amount on an accelerated basis would overcompensate the creditor by enabling him to receive and use the money sooner.") (emphasis added); *In re Thomson McKinnon Secs*., 149 B.R. 61, 75 (Bankr. S.D.N.Y. 1992) (same); *In re Chateaugay Corp.*, 115 B.R. 760, 770 (Bankr. S.D.N.Y. 1990) ("Once the value of the aggregate future [pension] liabilities has been determined, the present value of those future liabilities is determined as a matter of bankruptcy law so that all similar claims for future liabilities are treated in an economically similar manner.") (emphasis added), *vacated by consent order*, 1993 U.S. Dist. LEXIS 21409 (S.D.N.Y. June 7, 1993).

Similarly, courts regularly discount to present value other claims for non-interest bearing future obligations, outside of the employee benefit context. *See, e.g., In re Wis. Engine Co.*, 234 F. 281, 282-83 (7th Cir. 1916) (claims under non-interest bearing promissory notes must be discounted to present value); *In re O.P.M. Leasing Servs*., 79 B.R. 161, 167 (S.D.N.Y. 1987) (rejection damage claims for future installment payments must be discounted to present value) ("Equality of treatment at distribution is a fundamental principle underlying the bankruptcy laws.

By discounting a claim arising from the postpetition rejection of an executory contract or unexpired lease, the postpetition claimant is treated the same as the pre-petition claimant . . . .") (citation omitted); *In re Loewen Grp. Int'l*, 274 B.R. 427, 432-39 (Bankr. D. Del. 2002) (claims under non-interest bearing promissory notes must be discounted to present value). "The rationale for discounting all of these claims is the same – where a claim has been asserted in respect to a future liability of the debtor payable post-petition, the claim must be discounted to present value as of the petition date." *Loewen Grp.*, 274 B.R. at 437-38.

The City seeks to sweep under the rug all of this authority, not to mention common economic sense, by arguing that "[u]se of the word 'amount' indicates that 502(b) does not require a discount to present value."[20] The City, however, ignores that section 502(b) expressly commands the Court to "determine the amount" of claims "as of the date of the filing of the petition," 11 U.S.C. § 502(b), not some payment date in the future.

The City also attempts to distinguish certain of the cases cited by Franklin as relating to employment contract claims governed by section 502(b)(7) of the Bankruptcy Code (*Trace* and *Thomson*) or equipment leases governed by section 502(g) of the Bankruptcy Code (*O.P.M.*), but it never explains how or why that makes any difference.[21] It does not.

The City badly misreads *CF&I*, claiming that the Tenth Circuit "never ruled on whether reduction to present value was appropriate"[22] when, in fact, the Court specifically held that "the Bankruptcy Code mandates that all claims for future payment must be reduced to present value" and that, because pension "liabilities are for beneficiaries' payments that extend into the future, the amount of the liability must be reduced to present value so the debt can be dealt with under the reorganization plan." *CF&I*, 150 F.3d at 1300 (emphasis added). Similarly, the City also mangles *Chateaugay*, claiming that the case did not address whether "discount to present value was

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[20] *City's Response To Supplemental Objection Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013)* [DN 1435] at 25.

[21] *Id*.

[22] *Id*. at 26.

appropriate in the first instance."[23] In fact, however, *Chateaugay* directly holds that future pension liabilities must be discounted to present value "as a matter of bankruptcy law so that all similar claims for future liabilities are treated in an economically similar manner." *Chateaugay*, 115 B.R. at 770 .

In place of all of the authority cited by Franklin, the City relies primarily on the Third Circuit's decision in *Oakwood Homes*. That case, however, actually demonstrates that the Retiree Health Benefit Claims must be discounted to present value here. In *Oakwood Homes*, the Third Circuit held that it was inappropriate to discount claims for repayment of the principal of interest-bearing obligations because "the interest has already been disallowed pursuant to § 502(b)(2)." *In re Oakwood Homes Corp*., 449 F.3d 588, 600 (3d Cir. 2006). In reaching that conclusion, the Third Circuit explained the critical difference between interest-bearing future obligations (which are not to be discounted to present value) and non-interest bearing obligations (which must be discounted to present value), using the example of two 10-year promissory notes for $1,000, one with no interest and one bearing interest at 5%:

> The point is to recognize what the creditor bargained for, while avoiding a windfall. The key difference between interest- and non-interest- bearing debt is in that bargain – the holder of a *non-interest-bearing* note bargained to receive only his $1,000, spread out over the 10 years. The holder of *interest*-bearing debt, however, bargained for much more than the $1,000 – $1,628.89, in fact. Giving him $1,000 today, then, means that by the end of what would have been the note's 10-year lifetime, he could have reinvested at the same theoretical rate of interest, and earned his $1,628.89. A creditor who bargained to receive only the $1,000 in principal, without interest, would be fully compensated by $613.91, which he would be able to grow into his $1,000 by the end of the 10 years; not so for the creditor who bargained to receive interest, who is shortchanged by only receiving $613.91.

Id. at 601 (underlined emphasis added) (italics in original). The emphasized language clearly shows that the Third Circuit endorsed (not rejected) the discounting of non-interest bearing claims

[23] *Id*.

for future liabilities like the Retiree Health Benefit Claims. Its holding on that point is fully consistent with all of the authority cited by Franklin.[24]

Indeed, the contrary proposition advanced by the City contradicts its practice in this case and makes no sense. Under the City's view, the appropriate way to calculate the Retiree Health Benefit Claims is simply to tally up the amounts the City would pay for health care over the next forty to fifty years. In contrast, however, the City did not calculate Franklin's claim that way – it did not tally up the scheduled debt service payments it was supposed to make to Franklin over the next twenty-six years. Instead, it properly allowed Franklin a claim equal to the principal and accrued pre-prepetition interest on that principal, disallowing all amount for postpetition interest. The City, in other words, discounted Franklin's claim to present value as of the Petition Date. It must do the same in respect of the Retiree Health Benefit Claims.

The City's methodology also defies economic reality. The City could have purchased an annuity or insurance policy sufficient to cover its projected future obligations to pay for retiree health benefits. By definition, the purchase price for that annuity or insurance policy would have been far less than the total amount the City projected it would have to spend in the future on those benefits because, as the case law confirms, it is basic "economic reality that a sum of money received today is worth more than the same amount received tomorrow." *Trace*, 284 B.R. at 38. In this context, the City's assertion that retirees have a claim for the entire amount the City might have had to pay for their benefits over the next half century – notwithstanding the fact that the City could have insured itself against those obligations for a far lower amount – asks the Court to disregard economic reality and enter a fantasy land of the City's own making. The Court should decline that invitation.

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[24] The only other case cited by the City is simply wrong. In *Gretag Imaging*, the court held that the reasoning of *Oakwood Homes* is "equally compelling" as applied to non-interest bearing obligations. *In re Gretag Imaging, Inc.*, 485 B.R. 39, 46 (Bankr. D. Mass. 2013). That conclusion inexplicably ignores the clear distinction drawn by the Third Circuit between interest-bearing and non-interest bearing obligations and the Third Circuit's holding that a claim on a non-interest bearing obligation (like the Retiree Health Benefit Claims) would be fully compensated by an amount far less than the compensation required of a claim on an interest-bearing obligation.

Simply put, the Bankruptcy Code mandates that claims for non-interest bearing future liabilities like the Retiree Health Benefit Claims be discounted to present value. The City's failure to do so here vastly overstates the actual amount of its liability for retiree health benefits – some of which would not have been payable until forty or more years in to the future – and harms Franklin by reducing the amount to be paid on its unsecured claim by more than half.

CONCLUSION

In failing to discount the Retiree Health Benefit Claims to present value, the City violated its past practices, the standards of the Governmental Standards Accounting Board, and the fundamental strictures of the Bankruptcy Code.

The Court therefore should alter and amend its findings of fact and conclusions of law in order to sustain Franklin's objection and reduce the aggregate allowed amount of the Retiree Health Benefit Claims to the discounted present value of $261.9 million. Doing so will have no impact on retirees – who will receive the same treatment and distributions on their claims as now provided in the Plan – but will more than double the meager distribution on Franklin's unsecured claim, from a fractional payment of 0.93578% to one of 1.94731%.

Dated: November 12, 2014

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