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**UNITED STATES BANKRUPTCY COURT**

**EASTERN DISTRICT OF CALIFORNIA**

**SACRAMENTO DIVISION**

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| In re:<br><br>CITY OF STOCKTON, CALIFORNIA;<br><br>Debtor. | Case No.: 12-32118 (CMK)<br><br>DC No. CSH-1<br><br>**Chapter 9**<br><br>**BRIEF FOR SAVE OUR SONOMA ROADS AS AMICUS CURIAE IN SUPPORT OF FRANKLIN HIGH YIELD TAX FREE INCOME FUND AND FRANKLIN CALIFORNIA HIGH YIELD MUNICIPAL FUND REGARDING CONFIRMATION OF FIRST AMENDED PLAN OF ADJUSTMENT OF DEBTS OF CITY OF STOCKTON, CALIFORNIA (NOVEMBER 15, 2013)**<br><br>Date: May 12, 2014<br>Time: 9:30 a.m.<br>Judge: Hon. Christopher M. Klein<br>C. Courtroom 35 |

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Save Our Sonoma Roads ("SOSroads") supports Franklin High Yield Tax Free Income Fund and Franklin California High Yield Municipal Fund's (hereinafter "Franklin Funds") objection, ECF No. 1273, regarding the confirmation of the First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013), ECF No. 1204 (the "Plan"). SOSroads respectfully submits that its perspective would aid the Court in resolving the pension fund issue in this case. The outcome here is likely to have direct effects on the road conditions within Sonoma County (the "County"). While the County is not technically bankrupt, it is able to meet its current cash obligations only by failing to maintain its deteriorating road system. It is a prime example of service delivery insolvency where out-of-control pension liabilities are strangling the delivery of public services. SOSroads is well-positioned to provide a unique insight into the real-world consequences likely to flow from the Court's decision.

## I. STATEMENT OF INTEREST OF AMICUS CURIAE SOSROADS

SOSroads is a California nonprofit corporation and operates for the promotion of public welfare within the meaning of 26 U.S.C. § 501(c)(4). It is likely the only private all-volunteer, grassroots organization in California that advocates improving local roads.[1] SOSroads exists to: (1) educate County residents about how roads are funded; and (2) advocate for more public funds to restore County roads. Information about SOSroads, which formed in October 2011, can be found at http://sosroads.org/.

SOSroads and its members have a substantial interest in persuading this Court to rule that public employee pension plans can be impaired in a Chapter 9 bankruptcy proceeding[2] and to reject the contrary position of the California Public Employees Retirement System

[1] Private groups that support enhanced funding for roads are typically comprised of contractors and labor unions who undertake such work as well as asphalt and concrete suppliers.

[2] This issue is raised in Summary Objection of Franklin Funds to Confirmation of First Amended Plan of Adjustment of Debts of City of Stockton, California (November 15, 2013), ECF No. 1273.

("CalPERs") and public employee labor unions.[3] The decision in this case will affect SOSroads and its members.

Sonoma County residents have for years been victimized by service delivery insolvency because pensions and benefits to County workers have risen dramatically. The County admits that "needed County road maintenance has been deferred for decades,"[4] and SOSroads has shown that County funding, adjusted for inflation, has sharply declined from the late 1980s until 2012.[5] The County has long acknowledged that "transportation revenues are woefully inadequate to address the road maintenance needs of Sonoma County,"[6] and that it is on a trajectory whereby "a significant portion, if not all" of its road system "would require total reconstruction with such costs nearing or exceeding the public asset value."[7]

The Metropolitan Transportation Commission reports that while the nine-county Bay Area average pavement condition index ("PCI") is 66 out of 100 points,[8] Sonoma County is the worst with a PCI of 44.[9] SOSroads has access to unpublished county-by-county data that indicate that Sonoma County's PCI ranks 56th among California's 58 counties. Sixty-five percent of Sonoma County roads are considered to be either poor or failed, and its rural roads (PCI 34)[10] increasingly resemble those in less developed nations.

[3] Sonoma County is subject to the County Employees Retirement Law of 1937, California Government Code, Title 3, Division 4, and its retirement system is not administered by CalPERS. This is irrelevant to the legal principle at issue.
[4] Sonoma County Board of Supervisors, Ad Hoc Committee on Roads at 3 (June 19, 2012) (hereinafter "June 2012 Supervisors Report"), *available at* http://sonoma-county.org/public_reports/documents/roads_report_20120619.pdf
[5] SOSroads White Paper No. 1, Sonoma County Roads Crumble as Funding Shrinks over Two Decades (Feb. 2012) (hereinafter "SOSroads White Paper"), *available at* https://docs.google.com/file/d/0B0eYi-5QaOh5ZTI1NmVlOTgtMWY3YS00MjM0LWJkYTAtMGRkYjQ4NDFjYjNk/edit?hl=en_US
[6] County of Sonoma, Department of Transportation & Public Works, The Road Ahead (2008) (hereinafter "The Road Ahead") at 1, *available at* https://docs.google.com/file/d/0B8l8HksmrsFEMjFiMTQwZjktNjc5Ni00MDQzLTkxNzgtOTVmZDgxMWQ5MGRi/edit
[7] *Id.* at 37.
[8] Metropolitan Transportation Commission, "Good" Grade Proves Elusive for Bay Area's Streets and Roads (Oct. 22, 2013) (hereinafter "MTC Report"), *available at* http://www.mtc.ca.gov/news/press_releases/rel624.htm
[9] Attachment 2 to MTC Report (hereinafter "MTC Attachment"), *available at* https://docs.google.com/file/d/0B0eYi-5QaOh5MEZZN2h5TTN6UDQ/edit
[10] *Id.* at 4.

County supervisors have declined to challenge union positions that future pension benefits cannot be negotiated largely because of concerns about incurring huge legal expenses. This severely limits the opportunities to restore the road system. Without a *deus ex machina* of a massive infusion of state or federal funds, the most available source of additional funds for roads is the $380 million General Fund in a $1.3 billion budget.[11] As explained below, an increasing and unsustainable portion of these funds is instead committed to pensions and other retiree benefits. If pension benefits are untouchable in a bankruptcy proceeding, imprudent promises to "one percent" of the County's residents condemn all residents to suffer when funds for basic services are starved. If much of the road system degrades to dirt or gravel, property taxes would decline as would the County economy. This would further weaken the County's ability to deliver essential services.

## II. SONOMA COUNTY'S UNSUSTAINABLE RETIREMENT OBLIGATIONS

As detailed above, Sonoma County residents are experiencing service delivery insolvency. The County will soon approach balance sheet insolvency when the Government Accounting Standards Board requires it to recognize a $1 billion reduction in net assets.[12] Sonoma County has more retirees than active workers.[13] Its pension problems exemplify Warren Buffet's warning that "[l]ocal and state financial problems are accelerating, in large part because public entities promised pensions they couldn't afford."[14]

It is difficult to locate Sonoma County documents that report the total cost of its current pension obligations, let alone projections of future costs. The adopted budget for 2013-2014 is silent but provides an outdated "pension cost" (precise meaning unexplained)

[11] County of Sonoma, California, Adopted Budget Schedules 2013-2014 at 12 (hereinafter "Adopted Budget Schedules"), *available at* http://www.sonoma-county.org/auditor/financial_reports.htm
[12] New Sonoma's Financial Analysis of the County's Pension Crisis (Feb. 2014) at 3 (hereinafter "New Sonoma Pension Report"), *available at* http://newsonoma.org
[13] It has 3,830 active employees and 4,385 retirees (including disability retirements). Sonoma County Employees' Retirement Association Board Minutes (Jan. 16, 2014) a 1, http://www.scretire.com (Administration, Minutes Archive). These figures are as of December 31, 2013.
[14] Luciana Lopez, *Buffett says more bad news on pension funds during next decade*, REUTERS (Mar. 1, 2014), *available at* http://webcache.googleusercontent.com/search?q=cache:Tg55h05_7GEJ:www.reuters.com/article/2014/03/01/buffett-letter-munis-idUSL1N0LY0BT20140301+&cd=1&hl=en&ct=clnk&gl=us

of $73.5 million for 2011-2012.[15] Fortunately New Sonoma, a volunteer group of financial experts (http://newsonoma.org/), has conducted an in-depth analysis.

From the 1940s until 2002, Sonoma County had a sustainable pension system that provided up to 60 percent of salary together with social security and health care benefits.[16] Just prior to 2002, annual pension costs were about $20-25 million.[17] In 1999 the legislature enacted S.B. 400 to allow retroactive pension increases of 50 percent to state workers and authorized counties to provide similar windfalls to their employees.[18] In 2002 Sonoma County was one of a handful of counties to enact retroactive pension increases at the highest allowable formula of 3 percent of salary per year.[19] New Sonoma argues persuasively that the County did not adhere to state law in adopting this increase because the supervisors failed to perform a required actuarial study or notify the public as required by § 7507 of the California Government Code.[20] The decision is tainted by the fact that the supervisors and senior employees who advised them that increasing benefits retroactively was prudent greatly benefitted when their own pensions increased dramatically.[21] The changes took effect for safety workers in 2003 and 2006 and for general employees in 2004, increasing pensions for new retirees by 50 percent. The average age of new retirees declined from 62 to 57.[22] Thus new retirees paid into the retirement system for five fewer years and received pensions five years sooner. It doesn't take a statistician to recognize these changes can devastate a pension fund. Super-charged pensions beginning in 2004 are the heart of Sonoma County's financial

[15] Adopted Budget Schedules at 213.
[16] New Sonoma Pension Report at 1.
[17] *Id.*
[18] S.B. 400, 1999-2000 Reg. Sess. (Cal. 1999).
[19] New Sonoma Pension Report at 2. "Retroactive" means that in some cases a 30 year employee could suddenly retire at 90 percent of salary instead of 60 percent of salary.
[20] *Id*.
[21] For example, Rod Dole, the County's former chief financial officer, received a $254,625 pension at age 58. Brett Wilkison, *New pension data show 98 county retirees receive more than $100K annually.* SANTA ROSA PRESS DEMOCRAT (Sept. 21, 2011), *available at* http://www.watchsonomacounty.com/2011/09/county/new-pension-data-shows-98-county-retirees-receive-more-than-100k-annually/
[22] New Sonoma Pension Report at 2.

problems.[23] Exacerbating these problems, and generally unknown to the public, retirees have dramatically boosted their lifetime pensions by "spiking" their last year with overtime and non-salary payments to boost pension amounts and purchasing "air time" to add years in the retirement formula.[24]

The County's pension costs have quintupled from $24 million in 2001 to $122 million in 2012.[25] These costs, together with payments to service pension obligation bonds and health care costs, are projected to cost $209 million per year by 2020.[26] Unfunded liabilities at the end of 2012 totaled $1.3 billion,[27] which is unrealistically low because it assumes the County will earn 7.5 percent on its investment earnings.[28] Retirees managing their own funds typically limit spending to about 4 percent per year of the value of their assets.[29] The leading Sonoma County newspaper editorialized this month that "trusting that the stock market will somehow resolve [the pension problem] . . . is how we got into this fix in the first place."[30] New Sonoma has concluded that pension costs "have caused deep cuts to services and have greatly reduced the County's ability to maintain its roads and infrastructure."[31]

## III. ARGUMENT

Neither CalPERS nor any public employee retirement fund should emerge unscathed from a municipal bankruptcy. Such a result would be contrary to law, as summarized below. It would also have negative implications for Sonoma County and other entities throughout California that are experiencing service delivery insolvency. The Court has ample authority

[23] *Id*. at 5 (chart titled New General Retirees).
[24] New Sonoma has found examples of employees paying $28,000 for five additional years of service credit, boosting the pension by $12,000 per year ($300,000 in 30 years).
[25] New Sonoma Pension Report at 7 (chart titled Growth of County and Employee Contributions).
[26] *Id*.
[27] *Id*. at 8. This sums unfunded pension liabilities ($527 million), medical liabilities ($297 million) and remaining pension bond debt ($495 million).
[28] *Id*.
[29] *See, e.g.,* Eilene Zimmerman, *4% Rule for Retirement Withdrawals Is Golden No More*, NEW YORK TIMES (May 14, 2013), *available at* http://www.nytimes.com/2013/05/15/business/retirementspecial/the-4-rule-for-retirement-withdrawals-may-be-outdated.html?_r=0
[30] PD Editorial: *The Dangers of Ignoring San Jose Mayor*, SANTA ROSA PRESS DEMOCRAT (Mar. 2, 2014), *available at* http://www.pressdemocrat.com/article/20140302/opinion/140229495
[31] New Sonoma Pension Report at 3.

to impair Stockton's largest unsecured creditor, the 800 pound gorilla in the courtroom, to protect ordinary citizens from the effects of unaffordable public pensions that are becoming a dagger in the heart of our society.

The "Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land." U.S. CONST. art. VI, cl. 2. Where the Constitution grants the federal government the power to act, the Supremacy Clause establishes that federal law preempts state law. *See Perez v. Campbell*, 402 U.S. 637, 652 (1971) ("any state legislation which frustrates the full effectiveness of federal law is rendered invalid by the Supremacy Clause"). "Congress shall have Power [t]o . . . establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST., art. I, § 8, cl. 4. It is self-evident that this federal court is applying the federal Bankruptcy Code and here "[t]he Federal government possesses supreme power . . . ." *People of the State of N.Y. v. Irving Trust Co.*, 288 U.S. 329, 333 (1933). "[T]he Framers' primary goal was to prevent competing sovereigns' interference with the debtor's discharge. . . ." *Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356, 373 (2006).

The fundamental purpose of bankruptcy "is to interfere with the relations between the parties concerned – to change, modify, or impair the obligation of their contracts." *Ashton v. Cameron Cnty. Water Improvement Dist. No. 1*, 298 U.S. 513, 530 (1936). Out-of-control pension liabilities are merely contracts that, like any other, can be changed when a municipality is insolvent. The court in the largest municipal bankruptcy in history recently ruled that pension rights are contractual and "are subject to impairment in a federal bankruptcy proceeding." *In re City of Detroit*, 504 B.R. 97, 154 (Bankr. E.D. Mich. 2013). In that case pension reductions up to 10 percent (police and fire) and 34 percent (all others) have been proposed.[32] This court has recognized that conflicting California statutes and the California Constitution are preempted in a chapter 9 case. *See Ass'n of Retired Emps. of the City of Stockton (In re City of Stockton)*, 478 B.R. 8, 16-17 (Bankr. E.D. Cal. 2012). Rulings that federal bankruptcy law preempts and renders unenforceable contrary state law are not

[32] Plan for the Adjustment of Debts of the City of Detroit ¶¶ 138, 193, *In re City of Detroit*, No. 13-53846 (Bankr. E.D. Mich. Feb. 21, 2014), ECF No. 2708.

unique in California bankruptcy courts. *See In re Cnty. of Orange*, 191 B.R. 1005, 1017 (Bankr. C.D. Cal. 1996) (the "California legislature cannot rewrite bankruptcy priorities"); *In re City of Vallejo*, 403 B.R. 72, 75 (Bankr. E.D. Cal. 2009), *aff'd*, 432 B.R. 262 (E.D. Cal. 2010) (California labor law and the California Constitution are preempted by the Bankruptcy Code).

If the Court concludes that Stockton's pension obligations cannot be impaired serious ramifications throughout the state could ensue. Vallejo failed to address its pension liabilities and "now faces the risk of a second bankruptcy."[33] Requiring that pension obligations be restructured along with all of Stockton's other debts in this case would have a salutary effect on the ability of supervisors to address the failure to provide essential services in Sonoma County and elsewhere. It would remove the handcuffs from public officials when they negotiate with unions who seem to believe that the fiscal condition of their employer will never impact their members no matter how onerous the effects on the local jurisdiction. If the Court permits Stockton to sweep the pension issue under the rug, it will put off the day of reckoning and make the inevitable solutions more difficult because pension funds in Sonoma County and throughout the state will be further depleted. CalPERS intimidates many jurisdictions because it appears to have an unlimited legal budget, ultimately paid for by the state treasury. SOSroads urges the Court to address and to resolve this issue.

Unaffordable salary and benefit obligations to County workers and retirees contribute to the third world condition of Sonoma County roads. A decision to require pensions to be impaired in this case might ultimately serve to avoid future Chapter 9 bankruptcies. Public employee unions might be more willing to negotiate claw backs of retroactive pension increases, spiking, air time, and similar questionable if not unethical practices if the alternative were to take their chances with impairment in a bankruptcy proceeding.

[33] Moody's Investors Service, Bankrupt California cities face steep climb to solvency without pension relief (Feb. 20, 2014), *available at* https://www.moodys.com/research/Moodys-Bankrupt-California-cities-face-steep-climb-to-solvency-without--PR_293349#

## IV. CONCLUSION

For these reasons, SOSroads supports Franklin Funds request that the Court deny confirmation of the Plan and order that any revised plan include concessions by CalPERS.

DATED: March 31, 2014

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