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2410 Hyde Park Rd., Suite B
Jefferson City, MO 65109
Phone: (573) 616-1895

www.nappa.org

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Brenda Faken, *Administrative Technician*
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Mark Your Calendar

2016 Winter Seminar
Washington, DC
Omni Shoreham
February 17 - February 19, 2016

2016 Legal Education Conference
New Orleans, LA
Astor Crowne Plaza
June 21 - June 24, 2016
New Attorney Session on June 21st

2017 Legal Education Conference
Monterey, CA
Portola Hotel
June 27 - June 30, 2017
New Attorney Session on June 27th

Welcome to....

Photo Courtesy of Austin Convention & Visitors Bureau

2015 Legal Education Conference
June 23-26, 2015
(New Attorney Session on June 23rd)

There's a local joke in Austin that says "You can see Texas from here," and while it's true that Austin is sometimes at odds with its neighbors, that joke just reflects the truth that Austin shares the same spirit of independence that characterizes the Lone Star State. Often cited as one of the most distinctive cities in the US and a very popular tourist destination, Austin offers a unique blend of cultures for visitors.

NAPPA's **Legal Education Conference** will be held **June 23-26** at the Hilton Austin, right in the heart of Austin's entertainment district, within easy walking distance of many of the features that make the city fascinating. Austin has become famous worldwide for its music scene, and the conference hotel lies near the nexus of 6th Street and Red River with dozens of venues in every direction. Austin's clubs feature all kinds of music, from traditional country and folk to techno, jazz, and rock, sometimes all within a single block! Although downtown is still the center of Austin's music culture, the evening club scene has spread throughout the city, especially south of the Colorado River.

Austin can be pretty warm in June (some of you might even call it hot!), so you will want to dress for summer and take advantage of the evenings, maybe take a walk down to where the Colorado River (called Ladybird Lake here in honor of the former First Lady) flows through downtown, have a meal at one of the fine restaurants, margaritas at one of the local Mexican food restaurants, or a delicious, economic snack at one of Austin's numerous, eclectic food trucks. If you are on the banks of the river near sunset, near the Congress Avenue Bridge, you are likely to see one of Austin's natural wonders, the sudden dramatic flight of thousands of Mexican Free-Tailed Bats from the largest urban bat colony in the world.

If you have some time and a car, you will want to take a drive through the beautiful Hill Country west of town, where many of America's most prominent, high-tech companies have established offices and service centers. Austin is often called Silicon Hills these days with good reason, and the countryside itself is gorgeous, with rugged terrain surrounding blue lakes.

Other attractions in the city include the massive Texas State Capitol with its historic dome and legislative chambers and an impressive underground extension that expresses the nature of Texas government in marble and mosaic. The Bob Bullock History Museum, only a short walk from the Capitol, offers a creatively designed guide to the state's proud history.

Mostly, Austin is just a great place to relax. Culturally rich and full of interesting people, you may find that a walk down Congress Avenue provides plenty of entertainment with no itinerary at all.

Back in the middle of the 19th Century, when America was looking westward, houses all over the young country were said to have signs hung on their doors that said "Gone to Texas." We're hoping you'll hang one on your door this June!

Your 2015 Host Committee:

Christine Sweeney, *Texas Municipal Retirement System*
Carolina C. de Onis, *Teacher Retirement System of Texas*
Ann McGeehan, *Texas County and District Retirement System*

Want to Preclude Municipal Bankruptcies Filed to Discharge Pension Obligations? Amend Your Bankruptcy Authorization Statute, Pronto

By: Marc Lieberman

Financially-strapped cities, towns and counties ("Municipalities") are increasingly filing bankruptcy in an effort to discharge or reduce their public pension obligations.[1] Federal law allows Municipalities (but not states[2]) to seek protection under Chapter 9 of the United States Bankruptcy Code (the "Code"), *but only in the event such recourse is permitted by state law. See* 11 United States Code ("USC") § 901 *et seq.* Many states impose restrictions and qualifying criteria upon Municipalities attempting to file for Chapter 9 bankruptcy, with only about half of the states specifically authorizing Municipalities to file.[3] Only 12 states specifically authorize Chapter 9 bankruptcy filings by Municipalities without condition.[4]

This article will briefly discuss the major issues arising in connection with a municipal bankruptcy, if only to emphasize that public pension benefits might indeed be subject to impairment in municipal bankruptcy proceedings, despite state constitutional provisions precluding such impairment. The article will then propose prophylactic measures to preclude such filings altogether.

The Prerequisites of a Municipal Bankruptcy Filing

To qualify for relief under Chapter 9 of the Code, a Municipality must not only have authority under state law to file for bankruptcy but must also be: (i) insolvent; (ii) willing to effectuate a plan of readjustment; and (iii) either have (a) obtained the agreement of creditors holding a majority amount of the claim of each class of debt that the Municipality intends to impair, or (b) have attempted to negotiate in good faith, but was unable to do so or it was impractical to negotiate with creditors (or a creditor has attempted to obtain a "preference"[5]).[6] In those cases where state law authorizes Municipalities to seek relief in bankruptcy, it is presumed that they will be willing to effectuate a plan of readjustment if they file for relief under Chapter 9 of the Code. Thus, upon any initial filing, the initial contest will concern whether the Municipality filing for relief (the "Debtor") is really insolvent and further, whether it attempted to negotiate with its creditors in "good faith" but was unable to do so or it was impractical to negotiate (or a creditor attempted to obtain a preference).

The Interplay of Constitutional Protections for Public Pension Benefits

Assuming such concerns are overcome, the real dispute will then turn on whether the Debtor can propose to pay less than its full pension obligations, despite state constitutional provisions protecting pensions from impairment. For example, in Arizona, Art. XXIX, § 1(C) of the Arizona Constitution specifically protects public pensions from legislative impairment, as follows:

> Membership in a public retirement system is a contractual relationship that is subject to Article II, section 25, and public retirement system benefits shall not be diminished or impaired.

Art. XXIX, § 1(C) has been construed as having two separate parts: the "Contract Clause" and the "Pension Clause."[7] The Contract Clause is the first half of the provision referencing Art. II, § 25 of the Arizona Constitution. Facially, Art. II, § 25 prohibits the government's impairment of existing contracts:

> No... law impairing the obligation of a contract, shall ever be enacted.

Despite the fact that the language of the Contract Clause appears absolute, the courts have construed it to permit legislation to impair contractual rights *if* certain elements are satisfied.[8]

The second half of Art. XXIX, § 1(C) of the Arizona Constitution is the "Pension Clause," which provides:

> public retirement system benefits shall not be diminished or impaired.

The Arizona Supreme Court has held that whereas the Contract Clause "applies to the general contract provisions of a public retirement plan," the "Pension Clause applies only to public retirement benefits," and confers "additional independent protection afforded by the Contract Clause."[9] The Court has further held that whereas the Contract Clause permits legislation to impair contractual rights if certain elements are satisfied, the Pension Clause does not permit legislation to diminish or impair retirement benefits under *any* circumstances.[10]

In light of such pronouncements, can Municipalities use Chapter 9 of the Code to reduce or even discharge their pension obligations to their employees, since such an act will definitely diminish or impair the employees' pension benefits? As of this writing, the answer to that question is unclear, although preliminary indications suggest that bankruptcy courts might indeed authorize the impairment of pensions for *active* as opposed to *retired* government workers.

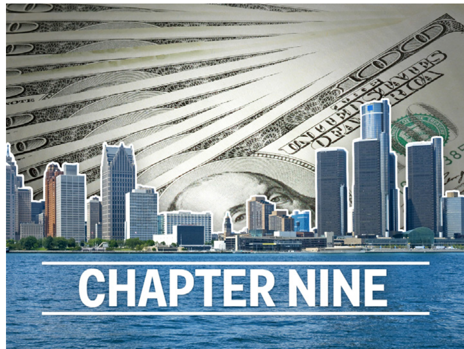
The Detroit Experience

The events unfolding in the State of Michigan as a result of the Detroit bankruptcy filing may provide insight concerning what other bankruptcy courts might do.

Michigan law allows Municipalities to file for relief under Chapter 9 of the Code if certain circumstances are present (*see* Mich. Comp. Laws § 141.1222). Further, Art. IX, § 24 of Michigan's constitution includes language similar to the Pension Clause in the Arizona

Want to Preclude Municipal Bankruptcies Filed to Discharge Pension Obligations? Amend Your Bankruptcy Authorization Statute, Pronto (continued)

Constitution. Under Art. IX, § 24 of the Michigan Constitution, pension obligations constitute "a contractual obligation... [that] shall not be diminished or impaired." Thus, the U.S. Bankruptcy Court's recent decision in *In re City of Detroit*,[11] wherein the court concluded that Chapter 9 of the Code permits the City of Detroit to reduce the pensions of its employees, despite language in the Michigan Constitution precluding diminishment or impairment of pension obligations, may be a harbinger of what a bankruptcy court in your state might find.



In the *Detroit* case, the bankruptcy court concluded that accrued pension benefits can be adjusted in Chapter 9, notwithstanding state laws prohibiting impairment.[12] The court's rationale was as follows:

Art. I, § 8, cl. 4 of the United States Constitution states that "Congress shall have the power... to establish... uniform laws on the subject of bankruptcies throughout the United States...." Pursuant to this authority, Congress enacted the Code, which explicitly empowers bankruptcy courts to impair contractual rights relating to accrued vested pension benefits.[13] Thus, while state constitutional provisions preventing the diminishment or impairment of pension contracts are enforceable to prevent a *State* from impairing pension rights, they do not prevent *federal* bankruptcy courts from doing so, for "[i]mpairing contracts is what the bankruptcy process does."[14] The court explained:

> In other words, while a state cannot make a law impairing the obligation of a contract, Congress can do so. The goal of the Bankruptcy Code is adjusting the debtor-creditor relationship. Every discharge impairs contracts. While bankruptcy law endeavors to provide a system of orderly, predictable rules for treatment of parties whose contracts are impaired, that does not change the starring role of contract impairment in bankruptcy. It follows, then, that contracts may be impaired in this Chapter 9 case without offending the Constitution. The Bankruptcy Clause gives Congress express power to legislate uniform laws of bankruptcy that result in impairment of contract; and Congress is not subject to the restriction that the Contracts Clause places on states.[15]

Since pension rights arise out of a contract, the court concluded that pension rights can be impaired by federal bankruptcy law so long as the state consents to be subject to federal bankruptcy laws.[16] "It follows that if a state consents to a municipal bankruptcy, no state law can protect contractual rights from impairment in bankruptcy, just as no law could protect any other type of contract rights."[17] The court further emphasized, "Stated another way, state law cannot reorder the distributional priorities of the bankruptcy code. If the state consents to a municipal bankruptcy, it consents to the application of chapter 9 of the bankruptcy code."[18]

The Court's Rejection of Section 903 Defenses

In due recognition of each state's sovereignty, Section 903 of the Code reserves certain powers to the states during the pendency of a municipal bankruptcy, and several retirement systems have argued that this section precludes bankruptcy courts from impairing government pension rights which are otherwise protected from impairment by state laws.[19]

Section 903 of the Code states:

This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—

> **(1)** a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and
>
> **(2)** a judgment entered under such a law may not bind a creditor that does not consent to such composition.

Pursuant to § 903 of the Code, bankruptcy courts cannot "interfere with the [municipality's] ability to continue its operations or dictate what type of services or level of services the debtor municipality may provide."[20] Section 903, however, "does not provide an independent substantive limit on the application of chapter 9 provisions."[21] In the Detroit bankruptcy proceedings, the City's retirement systems argued that § 903 of the Code required Michigan's constitutional protections for pensions to preempt the bankruptcy court's power to impair municipal contracts, but the court flatly rejected such arguments:

> A state cannot rely on the § 903 reservation of state power to condition or to qualify, i.e., to "cherry pick," the application of the Bankruptcy Code provisions that apply in chapter 9 cases after such a case has been filed. [Citations omitted]. **While a state may control prerequisites for consenting to permit one of its municipalities (which is an arm of the state cloaked in the state's sovereignty) to file a chapter 9 case, it cannot revise chapter 9** [Citations omitted].[22]

The retirement systems have appealed the Bankruptcy Court's decision to allow impairment of pension rights,[23] and perhaps only after that appeal is decided will we have better clarity whether public pension rights are subject to impairment in a Chapter 9 bankruptcy despite state constitutional prohibitions against the diminishment or impairment of retirement benefits.

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Want to Preclude Municipal Bankruptcies Filed to Discharge Pension Obligations? Amend Your Bankruptcy Authorization Statute, Pronto (continued)

Of course, if public retirement benefits can be impaired through a municipal bankruptcy, left unanswered is how precisely retirement benefits are to be treated in any plan of adjustment. This will depend on the condition of each Municipality, the other creditor constituents, and many other factors not capable of being readily surmised here. Nevertheless, the broad outlines of how the bankruptcy court might impair pension benefits can be gleaned from the few cases in which such matters have been addressed.

Possible Application of the Bankruptcy Code to State Pension Plans

Several provisions of the Code will apply to pension benefit claims. The most powerful is Code § 365, which governs the assumption or rejection of "executory contracts." An executory contract is one which has not yet been fully performed or, put another way, a contract under which both sides still have important performances remaining.[24] Under Code § 365, the Debtor (*i.e.*, the delinquent participating employer) may elect to "reject" an executory contract. In the pension context, a Municipality may argue that the pension rights of its active (in contrast to its retired) members are executory contracts which can be rejected.

If the right to a pension is determined to be an executory one, then pursuant to Code § 365 (as made applicable to Chapter 9 proceedings pursuant to Code § 901), the pension may be rejected.[25] The effect of rejection is that the contract is terminated and any damages as a result of the termination are treated as an unsecured claim that arose prior to the bankruptcy filing. Thus, the priority of the claim is the last rung of the claims to be paid out of available monies.

Whether a pension right is executory may be dependent upon whether it is "vested." In Arizona, for example, a right is "vested" when "the right to enjoyment, present or prospective, has become the property of some particular person or persons as a present interest."[26] Under another formulation, a right "vests" under Arizona law when "it is actually assertable as a legal cause of action or defense or is so substantially relied upon that retroactive divestiture would be manifestly unjust."[27]

Under Arizona law then, the right to government pension benefits "vests" "upon the commencement of employment."[28] And also under Arizona law, after such vesting, "[the pension] contract cannot be unilaterally modified nor can one party to a contract alter its terms without the assent of the other party."[29]

The Bankruptcy Courts are generally uniform in their decisions that vested benefits no longer satisfy the applicable definition of an executory contract and, therefore, cannot be rejected, so that benefits must continue to be paid and contributions for vested benefits must be made, *to the extent of available monies*. In the municipal bankruptcy context, however, the issue of whether rights are vested or unvested is likely to be determined based on *federal*, not state law, albeit the determination under federal law should be guided by state law.[30]

Generally, the bankruptcy courts in addressing private sector pension plans have concluded that, upon an employee's *retirement*, the contract between the parties is fully performed, and is no longer executory.[31] Conversely, the Bankruptcy Courts addressing private sector pension plans have also generally concluded that the pension rights of active employees may be executory contracts which can be rejected or modified, which has occurred in at least two bankruptcies.[32] Even the rights of vested pension plan participants may be modified as a result of negotiations. For instance, in municipal bankruptcies of the City of Pritchard, Alabama and Central Falls, Rhode Island, vested pension plan rights were modified through the plan process as a result of negotiations.[33]

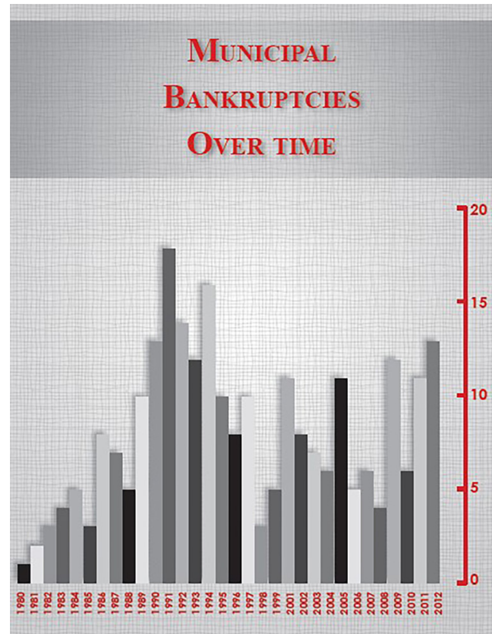
Thus, under the current state of the law, the pensions of current employees may be characterized as executory, subject to rejection in bankruptcy. The effect of rejection is termination of the contract and a resulting unsecured claim for the damages flowing from the termination. In contrast, the pensions of retired pensioners are likely to be characterized as "vested," and therefore, not subject to rejection. Accordingly, benefits payable to retirees must continue to be paid, notwithstanding any bankruptcy filing, although the issue then will become whether the payments are unsecured claims (because they arise from a pre-bankruptcy filing contract, which then means the claims may be subject to reduction in any plan of reorganization), or whether they are "administrative" claims (which in bankruptcy must be paid in full on the effective date of any plan of reorganization).[34] For purposes of brevity, we leave discussion of that issue to another day. One thing is certain: in the event pension rights are challenged in bankruptcy, there will be substantial litigation about how vested pension rights are to be characterized and therefore, prioritized for payment.

Prophylactic Legislation

Given the fact that to protect their members, state-wide public pension systems almost certainly will be drawn into any municipal bankruptcy of a participating employer, systems ought to consider whether to take prophylactic measures to preclude participating employers from discharging their pension obligations in bankruptcy. One relatively simple method of doing that would be to amend the state's bankruptcy authorization statute-- the statute which authorizes Municipalities to file bankruptcy under Chapter 9, to preclude Municipalities from filing for bankruptcy to discharge or reduce their public pension obligations. The case law addressing the authority of states to allow their Municipalities to file Chapter 9 petitions suggests that such a limitation might be enforceable.

Want to Preclude Municipal Bankruptcies Filed to Discharge Pension Obligations? Amend Your Bankruptcy Authorization Statute, Pronto (continued)

In *In re City of Vallejo*,[35] labor unions challenged the City of Vallejo's unilateral decision to modify its workers' collective bargaining agreements, arguing that state labor law prohibited impairment of the contracts.[36] The bankruptcy court disagreed, finding that language in Cal. Government Code § 53760, the statute which authorizes Municipalities to file for bankruptcy relief, did not "explicitly impose on California Municipalities limitations or restrictions that require compliance with or make applicable state labor laws."[37] Specifically, the court found that the language of this statute, which at the time provided that "except as otherwise provided by statute, a local public entity in this state may file a petition and exercise powers pursuant to applicable federal bankruptcy law" was not effective to carve out the labor agreements from the City's right to adjust its debts in bankruptcy. The unions argued that the language "except as otherwise provided by law" codified California's intent to allow Municipalities to file for bankruptcy only in certain circumstances, "but not to allow full preemption of all state laws in doing so."[38] In disagreeing with the unions, the court stated:



> This court declines to legislate from the bench and create a new exception to federal preemption. State labor law is not explicitly identified in California Government Code § 53760 as an exception to the general grant of authority for municipalities to pursue Chapter 9 bankruptcy. **If California had desired to restrict the ability of its municipalities to reject public employee contracts in light of state labor law, it could have done so as a pre-condition to seeking relief under Chapter 9. Its failure to take such action convinces this Court that the City was unequivocally authorized to exercise its right under Section 365 [of Chapter 9] and reject the [collective bargaining agreements] without interference from the state.**[39]

Thus, *City of Vallejo* acknowledges that in authorizing Municipalities to file for Chapter 9 bankruptcy, states may carve out certain debts from being adjusted in bankruptcy or limiting the debts a Municipality may adjust. In light of *City of Vallejo*, a public pension system might consider amending its particular bankruptcy authorization statute to preclude the discharge of public pension obligations. For example, the Arizona bankruptcy authorization statute-- A.R.S. § 35-603, could be amended as **(with material omitted reflected as ~~double strikeouts~~ and material added reflected by double underline):**

> Any taxing district or municipality in this state is authorized to file the petition provided for in the federal bankruptcy statute and to incur and pay the expenses thereof and any and all other expenses necessary or incidental to the consummation of the plan of readjustment contemplated in such petition or as may be modified from time to time, except that no municipality shall be empowered to petition for relief under the federal bankruptcy code, or seek relief therein, to diminish, impair, reduce, modify or discharge its public retirement system obligations in derogation of the rights afforded by Article XXIX, § 1(C) of the Arizona Constitution.

If enforceable, the above amendment would effectively preclude Arizona Municipalities from petitioning for bankruptcy to discharge or modify their contribution obligations. While the above amendment *might* well be enforceable, there is some risk that the "anti-discrimination rules" set forth in the bankruptcy Code might jeopardize the amendment's validity.

As explained above, a Municipality may file for bankruptcy under Chapter 9 of the Bankruptcy Code if state law authorizes such a filing. However, the goal of federal bankruptcy law is to allow for a "fair and equitable distribution to all creditors," such that all similarly-situated creditors have equal rights or access to the insolvent municipality's assets.[40] Congress' intent in allowing Municipal bankruptcy was to prohibit state law from conferring "preference on one class of creditors of one adjudged bankrupt under federal law even though the state may have the highest public purpose in attempting to do so."[41] Consequently, while states must grant authority for their Municipalities to be able to file bankruptcy under Chapter 9, once a state grants such authority, it "must accept Chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest."[42] To that end, "Chapter 9 does not permit individual states to override the priority scheme in the" Bankruptcy Code.[43] By way of example, in *In re County of Orange*, the bankruptcy court struck down as preempted a state law that gave priority to creditors holding a Municipality's funds in trust because the state law's priority conflicted with the priority scheme of the Bankruptcy Code.[44]

The upshot of the foregoing is that a bankruptcy court might find that *if* State law allows Municipalities to petition for relief under Chapter 9, State law cannot preclude certain Municipal debts (as opposed to others) from being discharged in bankruptcy. *If* that is the case, then allowing Municipalities to discharge all debts other than their public pension obligations would be unenforceable. On the other hand, the Code might allow states to preclude Municipalities from filing bankruptcy altogether if they have certain kinds of outstanding debts, and this is how the State of New York has addressed the issue. In New York, Municipalities cannot even petition for bankruptcy relief if they have certain kinds of outstanding debt.

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Want to Preclude Municipal Bankruptcies Filed to Discharge Pension Obligations? Amend Your Bankruptcy Authorization Statute, Pronto (continued)

In 2009, the New York State Assembly amended its municipal bankruptcy law, N.Y. Local Finance Law § 85.80, to preclude municipalities from filing for Chapter 9 bankruptcy if the Municipality had outstanding local American Recovery and Reinvestment Act ("ARRA") bond obligations. This statute now provides:

> A municipality or its emergency financial control board in addition to, or in lieu of, filing a petition under this title, or the city of New York or the New York state financial control board, may file any petition with any United States district court or court of bankruptcy under any provision of the laws of the United States, now or hereafter in effect, for the composition or adjustment of municipal indebtedness. Nothing contained in this title shall be construed to limit the authorization granted by this section. However, **no municipality shall file any petition authorized by this section for so long as its local ARRA bonds, as defined in section twenty-four hundred thirty-two of the public authorities law, purchased by the state of New York municipal bond bank agency and secured by its pledge of tax revenues pursuant to the authority of section twenty-four hundred thirty-six-b of the public authorities law remain outstanding.**[45]

Thus, while New York has authorized its Municipalities to file for Chapter 9 bankruptcy relief, this right is conditioned upon a Municipality's certification that it has no outstanding ARRA bond debt. The statute does not appear to have been challenged to date, so it is unclear whether a court would ultimately find that the law is a valid exercise of the state's sovereign right to dictate when its Municipalities may seek Chapter 9 bankruptcy relief or, alternatively, whether the law is preempted by federal bankruptcy law as violating the Bankruptcy Code's objective of creating a level playing field for all creditors. Ultimately, New York's municipal bankruptcy statute may serve as a model for an amendment to other State bankruptcy authorization statutes. Using Arizona's bankruptcy authorization statute as an example, such an amendment could provide as follows **(with material omitted reflected as ~~double strikeouts~~ and material added reflected by double underline):**

> Any taxing district or municipality in this state is authorized to file the petition provided for in the federal bankruptcy statute and to incur and pay the expenses thereof and any and all other expenses necessary or incidental to the consummation of the plan of readjustment contemplated in such petition or as it may be modified from time to time. Notwithstanding the foregoing, no taxing district or municipality is authorized to file a petition authorized by this section if the taxing district or municipality has any unfunded liability to any state or municipal public retirement plan or system.

This type of amendment would appear to comport with the purposes of federal bankruptcy law in that it gives Municipalities access to the totality of the Bankruptcy Code's rights and protections but is not an attempt by the state, once bankruptcy is filed, to "cherry pick" those provisions of Chapter 9 that it deems favorable. Rather, the amendment would simply render any Municipality with unfunded liability to a public pension plan ineligible to file for bankruptcy in the first place.

Municipal Bankruptcies

In the event a Municipality files for relief under Chapter 9 of the Bankruptcy Code to discharge its public pension obligations, it is very possible that a federal bankruptcy court will allow the Municipality to discharge a portion of its public pension obligations, even in the face of State constitutional prohibitions precluding impairment or diminishment of pension benefits.

Conclusion

In the event a Municipality files for relief under Chapter 9 of the Bankruptcy Code to discharge its public pension obligations, it is very possible that a federal bankruptcy court will allow the Municipality to discharge a portion of its public pension obligations, even in the face of State constitutional prohibitions precluding impairment or diminishment of pension benefits. To avoid such a result, public pension systems need to be proactive to prevent Municipalities from discharging their pension obligations. They can do this by amending their applicable bankruptcy authorization statutes to preclude Municipalities from filing bankruptcy to discharge their pension obligations. This is the best method of ensuring that public retirement systems continue to receive all contributions required to fund their members' pensions.

Marc R. Lieberman is the Chair of the Public Pension and Alternative Investments Group at Kutak Rock LLP.

ENDNOTES

[1]Eight cities, towns or counties have filed for bankruptcy since 2010: Detroit, Michigan, San Bernadino, California, Mammoth Lakes, California, Stockton, California, Jefferson County, Alabama, Harrisburg, Pennsylvania, Central Falls, Rhode Island, and Boise County, Idaho. *See* Brad Plumer, *Detroit Isn't Alone*, Washington Post, July 18, 2013 (http://www.washingtonpost.com/blogs/wonkblog/wp/2013/07/18/detroit-isn't-alone).

[2]While Art. I, § 8, cl. 4 of the United States Constitution states that "Congress shall have the power... to establish... uniform laws on the subject of bankruptcies throughout the United States...," the 10th and 11th Amendments to the Constitution (which place certain limits upon the federal government's recourse against the States) preclude the federal government from supervising the bankruptcy of a State. *See* J. Spiotto, *Primer on Municipal Debt Adjustment* (2012) ("Primer"), at 3.

Want to Preclude Municipal Bankruptcies Filed to Discharge Pension Obligations? Amend Your Bankruptcy Authorization Statute, Pronto (continued)

[3]*See* Primer at Appendix D.

[4]*See id.*; A.R.S. § 35-603. Section 35-603 provides that "[a]ny taxing district in this state is authorized to file the petition provided for in the federal bankruptcy statute and to incur and pay the expenses thereof and any and all other expenses necessary or incidental to the consummation of the plan of readjustment contemplated in such petition or as may be modified from time to time." This law was enacted in 1955, before the current version of the Code was enacted. The Code in effect in 1955 referenced Municipalities as "taxing districts." *See United States v. Bekins*, 304 U.S. 27 (1938). The current version of the Code now uses the word "municipality" for "taxing district." *See* 11 U.S.C. § 109(c). For purposes of this advice, we have assumed that a bankruptcy court hearing an Arizona Municipality's Chapter 9 petition would conclude that the reference to "taxing district" in A.R.S. § 35-603 means "municipality" as that term is used in the current Code.

[5]Section 547 of the Code permits a debtor in bankruptcy or its trustee to "avoid" (*i.e.*, force disgorgement or repayment of) transfers made within 90 days of a bankruptcy filing (one year if the transferee was an insider). Such transfers are referred to as "preferences" or "preferential transfers." The transferee's liability is enforced by the commencement of a lawsuit against any immediate and mediate transferees. The preference laws recognize that a financially troubled entity tends to pay only certain of its creditors, whether out of loyalty or necessity (usually insufficient cash flow). The preference laws are designed to promote the principle of equality of distribution among those who are creditors, not only on the filing date, but in the immediately preceding period as well.

[6]*See* 11 U.S.C. § 109(c).

[7]*See Fields v. Elected Officials' Retirement Plan*, 234 Ariz. 214, 218-219, ¶17, 1117, 320 P.3d 1160, 1164-65 (2014).

[8]*Id*. at 218, ¶16, 320 P.3d at 1164 (*citing Energy Reserves Group, Inc. v. Kansas Power and Light Co*., 459 U.S. 400 (1983)).

[9]*Id*. at 219-19, ¶17, 320 P.3d at 1164-65.

[10]*Id*. at 222, ¶37, 320 P.3d at 1168.

[11]504 B.R. 97, 145-54 (Bankr. E.D. Mich. 2013).

[12]*Id.*

[13]*Id*. at 150.

[14]*Id.*

[15]*Id. (quoting favorably, Association of Retired Employees v. City of Stockton, California ("In re Stockton")*, 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012).

[16]*Id*. at 154.

[17]*Id*. at 150 (*citing In re Stockton*, 478 B.R. at 16).

[18]*Id*. at 161.

[19]*See* Brief of Amicus Curiae California Public Employees' Retirement System in Support of Appellants Urging Reversal, *In re City of Detroit*, Docket Nos. 14-1208 et al (6th Cir. 2014), at 7-10.

[20]*In re County of Orange*, 191 B.R. 1005, 1018 (Bankr. C.D. Cal. 1996).

[21]*In City of Vallejo*, 403 B.R. 72, 75 (Bankr. E.D. Cal. 2009).

[22]*In re Detroit*, 504 B.R. at 161 (*quoting favorably, In Re Stockton*, 478 B.R. at 16-17) (emphasis added).

[23]*See In re City of Detroit*, Docket Nos. 14-1208 *et al*. (6th Cir. 2014).

[24]*See generally, In re Alexander*, 670 F.2d 885, 887 (9th Cir. 1982); Joanne Lau, *Modifying or Terminating Pension Plans through Chapter 9 Bankruptcies with a Focus on California*, 40 Fordham Urb. L. J. 1975 (October, 2013).

[25]An issue that may be raised is whether pension plans created by law are contracts in the traditional sense subject to being terminated under Section 365. In light of state laws characterizing pension benefits as contractual in nature, the most likely conclusion is that a Bankruptcy Court will conclude that pension plans are implied contracts and thus, may be subject to termination under Code Section 365.

[26]*Hall v. A.N.R. Freight System,, Inc.*, 149 Ariz. 130, 140, 717 P.2d 434, 440 (1986) (*quoting Steinfeld v. Neilsen*, 15 Ariz. 424, 465, 139 P. 879, 896 (1913)).

[27]*Id.*

[28]*Yeazell v. Copins*, 98 Ariz. 109, 115, 402 P.2d 541, 545 (1965). *See also Fund Manager v. City of Phoenix Police Department*, 151 Ariz. 487, 489, 728 P.2d 1237, 1239 (App. 1986) (stating that "a public employee's interest in a retirement benefit or pension is so significant that it should become a right or entitlement at the outset of employment").

[29]*Yeazell*, 98 Ariz. at 115, 402 P.2d at 545.

[30]Joanne Lau, *Modifying or Terminating Pension Plans through Chapter 9 Bankruptcies with a Focus on California*, 40 Fordham Urb. L. J. 1975 (October, 2013).

[31]*Id.*

[32]*Id.*

[33]*Id.*

[34]Jeffrey B. Ellman and Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 Emory Bankr. Dev. J. 365 (2011).

[35]432 B.R. 262 (2010).

[36]*Id*. at 265.

[37]*Id*. at 268.

[38]*Id*. at 269.

[39]*Id*. at 270 (emphasis added).

[40]*In re County of Orange*, 191 B.R. at 1015.

[41]*Id*. at 1017 (citing *Elliott v. Bumb*, 356 F.2d 749, 754-55 (9th Cir.), *cert. denied*, 385 U.S. 829 (1966)).

[42]*Id*. at 1021.

[43]*Id.*

[44]*Id.*

[45]Emphasis added.

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Treasury-IRS Regulatory Project Definition of Governmental Plan

By: Anthony (Tony) Roda

of "GOVERNMENTAL PLAN"

In November 2011, the Department of the Treasury and Internal Revenue Service (IRS) released an Advance Notice of Proposed Rulemaking (ANPRM) announcing their intention to issue regulations defining the term "governmental plan" under Internal Revenue Code (IRC) Section 414(d).[i] The ANPRM included a draft proposed rule and invited public comment. In addition to requesting written comments, the IRS held public hearings in Cleveland, Oakland, and Washington, D.C.

In part, the statutory language of Section 414(d) reads as follows:

> " ... the term 'governmental plan' means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing."

The draft proposed rule provides definitions for the following key terms: (1) established and maintained; (2) United States; (3) agency or instrumentality of the United States; (4) state; (5) political subdivision of a state; and (6) agency or instrumentality of a state or political subdivision of a state.

A facts and circumstances test would be used under the draft proposed rule to determine whether an entity is an agency or instrumentality of the U.S. or of a state or political subdivision of a state. Since NAPPA's focus is on state and local governmental pension plans, we should pay particular attention to the test that would be used to determine agency or instrumentality of a state or political subdivision of a state.

This test would be based on five main factors and eight other factors. The main factors are as follows: control of the entity's governing board or body; public nomination and election of members of the governing board or body; responsibility of the state or political subdivision for the entity's debts and liabilities, including benefits; the entity's employees are treated in the same manner as the employees of the state or political subdivision, except for benefits; and the delegation of sovereign powers.

The other factors to be examined are as follows: control of entity's operations by the state or political subdivision; direct funding through tax revenues or other public sources; specific enabling statute; treatment of the entity as a governmental entity for federal tax purposes; whether the entity is determined by state law to be an agency or instrumentality; court determination that the entity is an agency or instrumentality; state or political subdivision has ownership interest and no private interests are involved; and the entity serves a governmental purpose.

While few of us would argue that the factors – main and other – are worthy of inquiry for the purpose of divining the governmental status of an agency or instrumentality, there is no certainty that meeting four or five or even six factors would be sufficient to satisfy the test. As a consequence, in the view of many in the public pension plan community, myself included, more certainty and clarity is needed.

At the hearing held by the IRS in Washington in July 2012, some of the witnesses focused on the need for safe harbors and grandfather treatment. The creation of safe harbors was also a key element of the comments submitted by several national groups.[ii] In that comment letter a number of safe harbors were suggested, such as:

- A state or political subdivision has fiscal responsibility for the general debts and other liabilities of the entity, including employee benefit plans.
- A majority of the members of the governing board of the entity are either controlled by a state or political subdivision, including the power to appoint and/or remove a majority of the governing body, or are elected through periodic, publicly-held elections by the voters.
- The entity has been delegated one or more sovereign powers of a state or political subdivision.
- The entity has been established and empowered by specific statute or ordinance to be an agent of a state or political subdivision to perform a governmental function.
- The entity has been determined to be a governmental agency or instrumentality for purposes of federal income tax, federal employment tax, or for issuing tax exempt bonds.
- The entity has been treated as the agency or instrumentality of a state or political subdivision pursuant to a federal law (other than the IRC) or a federal agency (other than the IRS or Treasury).
- A state or federal court has determined that the entity is an agency or instrumentality of a state or political subdivision.

On the topic of grandfather treatment, the comment letter recommended that state and local governments be permitted to extend grandfather treatment to certain entities and their employees who are participants in governmental plans.[iii] Further, the letter asked that the same grandfather treatment apply in situations where the plan document allows non-profit instrumentalities to participate in a plan subject to approval by the plan's governing body, provided the governing body followed a good faith, reasonable interpretation of Section 414(d).

The draft proposed regulation would also seek to define the term *established and maintained*. The rule states that, " ... a plan is established and maintained for the employees of a governmental entity if—

Treasury-IRS Regulatory Project Definition of Governmental Plan (continued)

(i) The plan is established and maintained for employees by an employer, within the meaning of 1.401—1(a)(2);

(ii) The employer is a governmental entity; and

(iii) The participants covered by the plan are employees of that governmental entity.

Some have raised questions and submitted comments on situations where a plan is established by the state, but the plan benefits are solely for the employees of a municipality. In this example, the municipality would be the entity maintaining the plan through employer contributions. Multiple employer plans established under state law could have similar concerns.

The fundamental nature of the definition of governmental plan to NAPPA's members makes it incumbent on all of us to familiarize ourselves with the broad contours and specific provisions of the 2011 ANPRM, Treasury Notice 2015-7 and, of course, the proposed regulations that are ultimately released.

This portion of the draft proposed rule also covers changes of status by an employer, i.e., from a private entity to a governmental entity or vice versa. The draft proposed rule and the five illustrative examples on this point should be closely examined. They raise important questions related to the need for transitional relief where one or more employers of multiple employer governmental plans are found to not meet the definition of a governmental plan.

Another major topic discussed at the 2012 hearing was the controversy surrounding whether the inclusion of employees of charter schools in multiple employer governmental plans would jeopardize the governmental plan status of the broader plan. This issue received a tremendous amount of attention in the comment period. Of the approximately 2300 comments received on the ANPRM, some 2000 comments were submitted by the charter school community. These comments largely focused on the question of whether participation of employees of a charter school would cause a governmental plan to fail to meet the definition outlined in the ANPRM.

On January 23, 2015, the Treasury and IRS released Treasury Notice 2015-7 (the "Notice"), which provides further information and direction on the charter school topic. The Notice announces the anticipation that Treasury-IRS will issue proposed regulations that would create a five-part test (actually (a)-(e) in the Notice) that would need to be satisfied in order to meet the definition of a "public charter school." The Notice makes clear that the test will apply to defined benefit, defined contribution, Section 403(b), or Section 457(b) governmental plans. Comments on the Notice are due on May 11, 2015. There will also be an additional opportunity for public comment when the proposed regulations are released.

A summary of the five-part (a-e) test for a public charter school follows:

a. Non-sectarian independent public school serving governmental purpose by providing tuition-free elementary or secondary education, or both;

b. Established and operated in accordance with a specific state statute;

c. Participation in the state or local retirement plan is expressly required or permissible under applicable law;

d. The entity satisfies a multi-part test to ensure that it is controlled by a state, political subdivision of a state, or agency or instrumentality of a state or political subdivision of a state;[iv] and

e. All financial interests of ownership must be held by a state, political subdivision of a state, or agency or instrumentality of a state or political subdivision of a state.[v]

The Notice also addresses the issue of broad transition relief. It states that, "(t)he IRS and Treasury Department are in the process of reviewing each of these comments. It is expected that questions regarding broader transition relief will be addressed when proposed regulations are issued under § 414(d) of the Code."

NAPPA members will not know with certainty until the end of the regulatory process whether broad transition relief will be granted. However, we may be able to gain an insight into how the IRS and Treasury intend to deal with this question by examining what the Notice says on the transition rules for charter schools, specifically "(t)he IRS and Treasury Department anticipate that the final regulations under § 414(d) will apply prospectively and will include a delayed effective date." (Emphasis added). In addition, the 2011 ANPRM states that, "Generally, amendment of a State or local retirement plan requires enactment of State legislation. The Department of Treasury and IRS intends to take into consideration the time required to complete the State legislative process when determining an effective date for these regulations." Such treatment would be consistent with the extended effective date that was used in the latest guidance on the normal retirement age regulatory project.[vi]

The fundamental nature of the definition of governmental plan to NAPPA's members makes it incumbent on all of us to familiarize ourselves with the broad contours and specific provisions of the 2011 ANPRM, Treasury Notice 2015-7 and, of course, the proposed regulations that are ultimately released.

Tony Roda is a Partner at the Washington, D.C. law and lobbying firm Williams & Jensen.

Treasury-IRS Regulatory Project Definition of Governmental Plan (continued)

ENDNOTES

[i] 76 Federal Register 69172 (2011).

[ii] Letter by the National Conference on Public Employee Retirement Systems, the Government Finance Officers Association, the National Association of State Retirement Administrators, the National Council on Teacher Retirement, and the National Association of Government Defined Contribution Administrators. The letter was submitted to Treasury-IRS on June 15, 2012.

[iii] Ibid., 3. "An entity with a favorable private letter ruling under Rev. Rul. 89-49 or Rev. Rul. 57-128; An entity that is participating in the governmental plan pursuant to the specific terms of state or local law as of the effective date of the final regulations."

[iv] ... (d) The entity satisfies either paragraph (d)(1) or (d)(2) below.

(1) The entity's governing board or body is controlled by a State, political subdivision of a State, or agency or instrumentality of a State or of a political subdivision of a State. For this purpose, either (i) a State, political subdivision of a State, or an agency or instrumentality of a State or political subdivision of a State must have the power to nominate, appoint, remove, and replace a majority of the members of the entity's governing board or body, or (ii) a majority of the members of the entity's governing board or body must be publicly nominated and elected.

(2) In lieu of satisfying the requirements in paragraph (d)(1), the entity satisfies the requirements in paragraphs (d)(2)(i) through (d)(2)(iii) below.

   (i) The primary source of the entity's funding is from a State, political subdivision of a State, or agency or instrumentality of a State or political subdivision of a State.

   (ii) The rights of the entity's employees to their accrued benefits under the State or local retirement system are not dependent on whether the entity continues to participate in the system and, in the event the entity ceases participation, a governmental entity has responsibility for the accrued benefits of the entity's employees, including the continued funding of the accrued benefits, to no lesser extent than a governmental entity has responsibility for the continued funding of the accrued benefits of the employees of any other participating employer in the system in the event that other employer were to cease to be a participating employer.

   (iii) The entity is part of a local educational agency, as defined in 20 U.S.C. § 7801(26) (or is its own local educational agency), and is subject to the significant regulatory control and oversight by a State, political subdivision of a State, or agency or instrumentality of a State or political subdivision of a State, as described in paragraphs (d)(2)(iii)(1) and (d)(2)(iii)(2) below.

      (1) The entity is held accountable by an authorized public chartering agency as defined in 20 U.S.C. § 7221i(4), which has the power to approve, renew, and revoke the charter of the entity. For this purpose, the authorized public chartering agency must be authorized under State law to approve charters for the creation of independent public schools and to hold the entity accountable for results.

      (2) The entity is required to comply with health and safety standards, as well as academic and financial accountability standards, that are similar to those that are generally applicable to other public schools in the State.

[v] In order to satisfy this prong upon dissolution or final liquidation of the entity, the entity's governing documents must require the entity's net assets to be distributed to another public school that meets the requirements of this five-part test or to a State, political subdivision of a State, or agency or instrumentality of a State or political subdivision of a State.

[vi] Treasury Notice 2012-29 uses an effective date of the later of (1) January 1, 2015, or (2) the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after the date that is three months after the final regulations are published in the Federal Register.

Future NAPPA Conferences

2016 Winter Seminar

Washington, DC
Omni Shoreham Hotel
February 17 - February 19, 2016

2016 Legal Education Conference

New Orleans, LA
Astor Crowne Plaza
June 21 - June 24, 2016
New Attorney Session on June 21st

2017 Legal Education Conference

Monterey, CA
Portola Hotel
June 27 - June 30, 2017
New Attorney Session on June 27th

Municipal Pension Reform: A Case Study Involving the City of St. Louis and Its Firefighters

By: Patricia Winchell & Amanda Hettinger

By 2011, the pension costs for the City of St. Louis firefighters consumed nearly a third of the fire department's budget and represented more than 56% of the firefighters' payroll. The City's required annual payment to the pension fund in 2011 was over $23 million, an increase of over 500% from 2001. The City lacked the financial resources to sustain the funding. Faced with a choice between drastically reducing essential City services (including firefighting) and reducing the crippling costs of its firefighters' pension system, the City determined that it had to reduce pension costs. Knowing that any reforms it implemented would be immediately challenged in court, the City had to consider not only its need to reduce costs, but also Missouri law on the authority of municipalities to establish pension systems and restrictions under both the federal and state constitution on its ability to make changes to the firefighters' pensions. The City successfully defended its pension reforms at both the Missouri state trial and appellate courts, with decisions that became final earlier this year.

The pension system that existed in 2011, the Firemen's Retirement System ("FRS"), was originally created by the City in 1960 pursuant to a Missouri enabling statute.

Reforming the Pension System

The pension system that existed in 2011, the Firemen's Retirement System ("FRS"), was originally created by the City in 1960 pursuant to a Missouri enabling statute. The statute permitted cities to adopt a pension system for firefighters; the terms of the system were spelled out in the statute. The City ordinance creating the FRS mirrored the terms of the enabling statute. Historically, if changes to the firefighters' pensions were needed or desired, first the state legislature would amend the enabling statute. After the statute was amended, the FRS ordinance could be modified.

As the amount the City was required to contribute annually to fund the plan escalated exponentially, by 2011 the City was committed to changing the pension system so that both the system and the City were financially sustainable. The City was equally committed, however, to continuing to provide a defined benefit pension plan that would attract and retain qualified firefighters and to preserving the pension benefits that had been accrued under the FRS. Accordingly, the City began by identifying the FRS features that were most costly; determining whether and how those features could be modified in a new or amended defined benefit plan; and analyzing what cost savings could be achieved by the proposed modifications. This work involved a team that included the City's lawyers, representatives from the City's Budget Division, and actuaries retained by the City.

Under the FRS, a firefighter contributed 8% of annual salary to the FRS and could receive an immediate unreduced retirement benefit after 20 years of service regardless of age, plus a full cash refund of his contributions. The benefit formula was 2% of average final compensation for the first 25 years of service, and 5% for each additional year, up to a maximum of 75%.

The City identified the unreduced retirement benefit after 20 years of service, the contribution rate, and the refund of contributions at retirement as plan features that needed to be modified to make the system sustainable. Accordingly, under the new plan design, a firefighter would contribute 9% of annual salary to the pension fund, which was **not** refundable at retirement. An unreduced retirement benefit would be available only after a participant attained age 55 and performed 20 years of service. A participant could elect to commence retirement benefits before age 55, but those benefits would be subject to an actuarial reduction. The benefit formula would be essentially unchanged.

The increase in contribution rates, elimination of refunds of contributions on retirement, and the elimination of the unreduced retirement benefit prior to age 55 were the design changes most critical to the reduction of pension costs. Other design changes that also contributed to reduced costs for the City included limitations on cost-of-living increases and a change in the definition of average final compensation from a final two-year average to a final three-year average.

The City also determined that changes in the administration of disability pensions were necessary. In 2011, approximately 48% of those receiving payments from the FRS were receiving disability pensions. A front page article in the St. Louis Post-Dispatch during the course of the pension overhaul attested to abuses of the FRS disability benefit. The City proposed that disabled beneficiaries be required to undergo an independent medical examination periodically to recertify their eligibility for the benefit. Changes in the administration of disability benefits would have little immediate effect on the actuarially-certified amount the City was required to contribute to the plan annually, but were expected to reduce the cost of the pension significantly over the long-term.

Under the City's new plan design, all of the benefits accrued under the FRS prior to the date of any change were preserved, and the City's obligation to contribute annually the amount necessary to fund the plan as certified by the actuary was unchanged.

Once it had settled on a sustainable plan design, the City had to consider implementation. The design changes proposed by the City were plainly not consistent with the enabling statute and were opposed by the firefighters and by the majority of the Trustees of the FRS,

Municipal Pension Reform: A Case Study Involving the City of St. Louis and Its Firefighters (continued)

of whom five of the eight were active or retired firemen. Both the firefighters' union and the FRS Board refused to consider or discuss any pension benefit reductions whatsoever based on their position that the reductions would be unconstitutional. The possibility of an amendment to the enabling statute was remote at best, and the City wanted a pension system for City firefighters that was under local control and did not require the approval of the state legislature for changes. In short, the City wanted to opt out of the FRS.

Two ordinances were considered by the City's Board of Aldermen. One ordinance repealed the ordinances establishing and governing the FRS and froze benefit levels under the FRS at the level in place at the time of the adoption of a new plan for firefighters. The second ordinance adopted a new plan, the Firefighters Retirement Plan ("FRP"), into which the FRS was to be merged. The FRP would pay a participant a benefit equal to the benefits accrued under the FRS for service prior to the effective date of the new plan (taking into account service after the effective date for purposes of vesting and benefit commencement). For service after the effective date, the benefit would be calculated under the terms of the new plan based on total years of service, and then the benefit paid based on the FRS service would be offset.

The City was committed to continuing to provide a defined benefit pension plan that would attract and retain qualified firefighters.

Despite contentious hearings, protests, and threats of legal action by the firefighters, their union, and the FRS Trustees, the Board of Aldermen enacted the ordinance repealing the FRS and freezing benefit levels, but made its effectiveness conditional on the City's approval of a new plan for firefighters. Nearly three months later, the Board passed the ordinance adopting the FRP as a new pension plan for the City's firefighters and providing for the merger of the FRS into the FRP. The FRP Board would have seven trustees, three of whom would be active or retired firefighters.

Even before the pension reform ordinances took effect, the Trustees of the FRS, various City firefighters and the firefighters' union sued the City attacking the ordinances. In an order granting a preliminary injunction, the trial court ruled that while the City could opt out of the FRS, freeze the benefits, and adopt a new plan, it was not entitled under the enabling statute to divest the FRS trustees of management and control of the FRS assets and could not merge the FRS into the FRP. In response and before the trial court entered a final judgment, the City amended the ordinance adopting the FRP to eliminate the merger provision and provide instead for a dual plan approach. Under this approach, the FRS benefit earned up until the date the FRP went into effect would be paid from the FRS, which would continue to be administered by the FRS Trustees. The FRP would pay benefits for all years of service after its effective date and would be the only plan in which employees hired after the effective date would participate. Ultimately, the courts considered the legality of this dual plan approach.

The Litigation

The main issues in the litigation were: (1) whether the City had the right to repeal the FRS; (2) whether the City had the authority to implement a new pension system absent State enabling legislation; and (3) whether the pension reforms impaired the contractual rights of the City's firefighters, both those vested in the FRS and those not vested.

Both the trial and appellate courts held that the City had the right to repeal the FRS. The challengers argued that the City lacked this right because the enabling statute for the FRS was silent as to the City's right to repeal. Important to the courts' rejection of this argument was the City's status as a home rule city, and Missouri case law counseling that silence in a statute cannot serve as a prohibition on home rule power. The ordinances establishing the FRS had always contained an explicit provision reserving the City's unilateral right to repeal the system, which was sufficient authority for the repeal of the FRS. The fact that the FRS remained in place for the limited purpose of paying benefits accrued prior to termination did not alter the courts' determinations; the courts viewed the FRS as repealed because no new benefits could be accrued pursuant to that system.

The trial and appellate courts also held that the City's status as a home rule city granted it the right to enact the FRP independent of state enabling legislation. Specifically, because the State had the power to enable and enact pension systems under Missouri's constitution, the City likewise had the power to enable and enact pension systems, absent an explicit statutory prohibition to the contrary. The challengers argued that the enabling statute for the FRS prohibited the City from enacting any pension plan other than that described in the enabling statute. The enabling statute for the FRS was written in permissive, not mandatory, terms, however, and nothing in the statute stated that the pension system it enabled was exclusive. Indeed, had the courts held that the enabling statute was exclusive, the statute may have run afoul of a provision in Missouri's Constitution prohibiting the state legislature from setting the compensation of municipal employees.

Finally, the courts held that the pension reforms did not violate the contracts clauses in either the United States or Missouri Constitutions. Reaching this holding entailed a two-party inquiry: first, what were the terms of the contract; and second, did the reforms impair those contractual terms?

Municipal Pension Reform: A Case Study Involving the City of St. Louis and Its Firefighters (continued)

Looking at the language of the ordinances that created the FRS, the courts held that there was no contract between the City and its firefighters guaranteeing them the same level of future pension benefits in perpetuity. The ordinances establishing the FRS made clear that benefits only accrued once service was performed, and that these benefits did not vest until twenty years of service was performed. The ordinances were also silent as to any right to future benefit accruals. This, combined with the City's explicit reservation of the right to repeal the FRS at any time, negated any argument that the City had entered into a contract with its firefighters regarding future benefit accruals. Because no contract existed promising a certain level of benefits in perpetuity, the courts easily held that there was no contractual impairment because the pension reforms only impacted future benefit accruals—and even then only for firefighters not yet eligible to retire at the time the reforms became effective.

In addition to the legal issues just discussed, public policy was very much at play during the litigation. The challengers focused on the importance the firefighters had to the public welfare and the ways in which the firefighters relied on their pension benefits to replace Social Security. The City, in turn, focused on the difficult choice it faced of possibly closing down firehouses if the spiraling pension costs were not brought under control, and the import of a decision permitting it to repeal the FRS but not permitting it to enact a replacement system. A clear understanding of the reforms undertaken by the City was also imperative to resolve many of the legal issues facing the courts. Both the challengers and the City utilized actuaries to assist in explaining the benefit changes and cost impact of the reforms to the trial court.

While not easy, the City successfully navigated the complicated political and legal challenges it faced in implementing pension reforms for its firefighters pension system, and in doing so, still offers its firefighters a generous and competitive pension. The plan design changes will save the City's taxpayers an estimated $53 million over the next thirty years with significant additional savings expected from the changes in the administration of the disability pensions.

Patricia Winchell and Amanda Hettinger are Partners at the law firm of Thompson Coburn LLP.

Helping Your Members Protect Their Children with Disabilities: Supplemental Needs Trusts as Plan Beneficiaries

By: Julie Borisov and Jennifer Schreck

In New Jersey, a retired firefighter with a severely disabled child receiving public assistance benefits was worried that his child might lose that assistance upon the retiree's death.[1] Under the provisions of the retiree's pension plan, upon the retiree's death the child automatically became eligible for a survivor benefit from the Police and Firemen's Retirement System (PFRS). The federal and state programs providing public assistance to the disabled child, such as Supplemental Security Income (SSI) and Medicaid, measure the child's assets and income against an allowable limit in order to determine eligibility for these programs. Concerned that his child would lose eligibility for public assistance upon receipt of the survivor benefits, the retiree sought to have those benefits go into a supplemental needs trust for that child. The plan, as well as the lower courts, denied his request. On appeal, the Supreme Court of New Jersey determined that the supplemental needs trust could stand in the place of the disabled child for the purpose of receiving survivor benefits, providing:

> We reject as arbitrary, capricious, and unreasonable the Board's interpretive determination that foists on disabled children of PFRS retirees, such as the child involved here, what is essentially a forfeiture of survivors' benefits.[2]

The issues presented in *Saccone* regarding supplemental needs trusts and plan benefits due to disabled children of plan members and retirees are not unique to New Jersey. In some circumstances, disabled children may be unwittingly penalized by plan provisions governing benefit payments upon the death of members or retirees. This may occur, as in *Saccone*, when a pension plan's statutory framework automatically provides that a child receives survivor benefits upon a retiree's death. Or, it may occur when a retiree voluntarily elects a retirement option that makes benefit payments to his or her child upon the retiree's death, not realizing that such income to the disabled child would result in loss of public assistance payments. One solution can be amending a plan, either by statute or policy as may be applicable, to allow for plan payments to a supplemental needs trust

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Helping Your Members Protect Their Children with Disabilities: Supplemental Needs Trusts as Plan Beneficiaries (continued)

for a disabled individual upon the death of a member or retiree; thus preserving the disabled individual's eligibility for federal and state public assistance benefits. A number of pension systems around the country have statutory provisions and regulations or policies providing that a supplemental needs trust can be named as a beneficiary for benefit payment purposes.[3]

The Evolution of Supplemental Needs Trusts and Maintaining Eligibility

A disabled individual may qualify for government benefits from SSI and Medicaid that take care of the individual's basic needs, such as food, shelter and medical expenses.[4] Funded by federal and state resources, Medicaid provides health care to those who cannot afford it. SSI is a federal program that pays for food, clothing and shelter for disabled individuals. The qualification for such benefits is needs-based and is meant to provide for low-income individuals who do not have assets adequate to provide the care they need.[5] These benefits are generally available for those who have less than $2000 in countable assets.[6]

A trust created and structured specifically to provide for the supplemental expenditures of a disabled individual is generally referred to as a supplemental needs trust (SNT). It is a "discretionary trust established for the benefit of a person with a severe and chronic or persistent disability."[7] SNTs are usually funded with a disabled person's personal injury settlement, inheritance, or pension benefits. The funds received may be insufficient to cover the living expenses and the often extensive medical expenses that are needed. SNTs do not pay for expenses that are covered by public assistance, rather, they are "intended to provide for expenses that assistance programs such as Medicaid do not cover," and as such, the funds that go into a supplemental needs trust for a disabled individual do not generally affect the individual's eligibility for public assistance benefits.[8]

Prior to 1993, loved ones of disabled individuals used trusts to shelter the assets of the disabled individual from the programs that provided essential care. Congress viewed the trusts as a means of manipulation and abuse of the Medicaid system. In an attempt to stop the manipulation, Congress changed the law to state that assets "available" to an applicant for purposes of determining Medicaid eligibility included trust assets.[9] Faced with complaints from disability rights activists, the provision was repealed; but that left a vacuum in which trusts could be used to conceal assets with no regulations to stop manipulation.

In 1993, Congress passed the Omnibus Budget Reconciliation Act (OBRA '93) which created a presumption of "availability" for trust funds but codified two types of trusts as exceptions to the rule.[10] These were self-settled trusts and pooled trusts, which are described below. Outside of the OBRA regime are third-party trusts that hold inherited assets, which are not considered to be the assets of the disabled individual. These trusts are also described below.

Key to the maintenance of Medicaid and SSI eligibility is management of the trust by a trustee in strict compliance with applicable regulations. Distributions from the trust must not be made directly to the disabled beneficiary of the trust, and the distributions must be used only for the beneficiary's supplemental needs not provided for through Medicaid and SSI.

Self-Settled Trust

A self-settled trust is created pursuant to 42 U.S.C. § 1396p(d)(4)(A), and is also known as a "(d)(4)(A) trust" or a "first-party trust." These trusts must be settled by a parent or guardian with the assets of a disabled individual under age 65, such as a personal injury settlement. A self-settled trust must contain a "payback" provision under which any funds left in the trust after the beneficiary dies must be used to repay the state Medicaid agency for the public benefits. Also, payments to a self-settled trust must cease upon the beneficiary of the trust turning age 65.

Pooled Trust

Pooled trusts are managed by nonprofit associations that pool the funds of several disabled individuals for investment purposes. Each individual has his/her own "account" but the entity is just one trust. These trusts must provide that, upon the death of the beneficiary, the remaining funds in the account are either distributed to the other members of the pooled trust or used to pay back Medicaid.

Third-Party Trust

These trusts are considered to be an exception to the OBRA '93 legislation because they are funded with the assets of someone other than the disabled individual, unlike self-settled trusts and pooled trusts. OBRA '93 does not apply because the beneficiary of a third-party trust never owns the assets prior to forming the trust. These trusts are usually established by a parent, grandparent or legal guardian of the disabled individual by way of a will (testamentary trust) or inter vivos (created during the life of the grantor). The benefit of an inter vivos trust is that the grantor will be able to ensure that the trust is properly structured prior to the grantor's death. Third-party trusts do not have Medicaid "payback" provisions upon the death of the beneficiary, since they are funded with third-party assets. Third-party trusts are usually structured to pay remaining funds to siblings of the deceased beneficiary.

Colorado Public Employees' Retirement Association Experience

The SNT issue was recently brought to the forefront at Colorado PERA, resulting in a legislative change. At retirement, Colorado PERA retirees may name a cobeneficiary. Two plan retirees, who had each named their disabled child as cobeneficiary upon retirement, were concerned that payment of such benefits to the child upon the retirees' deaths would jeopardize the child's eligibility for public assistance. The retirees contacted Colorado PERA in order to explore options available to fix the problem. The first option reviewed, changing the cobeneficiary named at retirement from the child to the SNT, was not viable. Unfortunately, while Colorado law allowed changes in other situations,

Helping Your Members Protect Their Children with Disabilities: Supplemental Needs Trusts as Plan Beneficiaries (continued)

such as marriage and divorce, it did not allow a cobeneficiary change in this situation. Also, Colorado law only allowed a "person" to be named as a cobeneficiary, rather than a "trust". The second option reviewed, a waiver of the cobeneficiary's right to payment, was also not viable. Federal and state law governing public assistance considers benefit payments to be assets of the child even if such income is refused by the child or by someone on behalf of the child. For example, Colorado regulations provide that the assets of the disabled child include:

> All income or resources which the individual or such individual's spouse is entitled to but does not receive because of action by any of the following:
>
> i) The individual or such individual's spouse,
>
> ii) A person, a court, or administrative body with legal authority to act on behalf of the individual or such individual's spouse, or
>
> iii) Any person, court or administrative body acting at the direction of or upon the request of the individual or such individual's spouse.[11]

The third option, the assignment of the cobeneficiary benefits to an SNT upon the retirees' death, also proved not to be viable. State law governing Colorado PERA prohibits assignment of benefits to a trust of any kind in its anti-alienation provision.[12] Additionally, it is likely that even if assigned, the benefit would still be includable as income for public assistance eligibility based upon the regulation cited above.

However, a viable solution appeared to involve changing Colorado law to allow an SNT to be named as a cobeneficiary, and also allow retirees to retroactively change their cobeneficiary selection from their disabled child to an SNT benefiting that disabled child. A bill was soon drafted to be introduced into the Colorado General Assembly's 70th General Session in January of 2015.[13]

The bill allows a third-party SNT for the benefit of a retiree's disabled child to be a cobeneficiary, defining an SNT as a valid third-party trust that complies with the Colorado Medical Assistance Act and the Federal Social Security Act. Only a third-party SNT is allowed because Colorado PERA must be able to make payments to the trust for the lifetime of the beneficiary; a self-settled trust cannot accept benefits after the beneficiary turns age 65. Also, pooled trusts are not allowed; Colorado PERA must pay a trust with only one beneficiary due to the anti-alienation provision in Colorado law, and the SNT must be coterminous with the lifetime of such beneficiary. To address payment of benefits in the event an SNT is deemed invalid or revoked, the legislation provides that in such an instance, the beneficiary of the trust becomes the cobeneficiary and receives payments directly.

In addition to accommodating retirees with disabled children, Colorado PERA and the legislators championing this bill sought to protect disabled children eligible for a survivor benefit upon the death of their working parent. Much like the law in *Saccone*, upon a working parent's death, Colorado law automatically provides a monthly benefit to a child qualified under the plan, such as a child under the age of majority or a disabled child. The bill effectively does what the Court did in *Saccone* - requiring Colorado PERA to pay the survivor benefit to the SNT established for the disabled child. Again, if the SNT is determined invalid or terminates, the payments would be made to the child directly. At the time of the drafting of this article, the Colorado bill passed both chambers of the Colorado General Assembly and was signed by the Governor.

Conclusion

When deliberating an amendment of current statutes or policies to include references to SNTs, a few key issues for pension plans to consider include the type of SNT that complies with your statutory framework, whether the SNT could be established for various beneficiaries, such as children, spouses and dependent parents, and the types of instances where payments would be made by the plan to the SNT rather than directly to a beneficiary or survivor. Review of applicable tax law and anti-alienation statutes is also vital in ensuring that payments to SNTs comply with any applicable state and federal law.

Julie Borisov is a Staff Attorney and Jennifer Schreck is a Senior Staff Attorney at the Colorado Public Employees' Retirement Association.

ENDNOTES

[1] *Saccone v. Bd. of Trustees of the Police and Firemen's Retirement System*, 98 A.3d 1158 (N.J. 2014).

[2] *Id.* at 1159.

[3] *See* Tex. Gov't Code Ann. § 841.008(c) (West 2015); *see* La. Rev. Stat. Ann. 11:762(J) (2015); *see* 40 Ill. Comp. Stat. Ann. 5/1-120 (West 2015).

[4] Medicaid was created under Title XIX of the Social Security Act of 1965 (42 U.S.C. § 1396 *et seq.*). The Supplemental Security Income (SSI) program was created under Title XVI of the Social Security Act (42 U.S.C. § 1381, *et seq.*).

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[5]*See Cook v. Dep't of Soc. Servs*., 570 N.W.2d 684 (Mich. Ct. App. 1997); *see White ex rel. Smith v. Apfel*, 167 F.3d 369 (7th Cir. 1999).

[6]Katherine B. McCoy, *The Growing Need for Third-Party Special Needs Trust Reform*, 65 Case W. Res. L. Rev. 461, 469 (2014).

[7]*Sullivan v. County of Suffolk*, 174 F.3d 282 (2nd Cir. 1999), *citing* N.Y. Est. Powers & Trusts Law § 7–1.12(a)(5) (McKinney 1998).

[8]*Sullivan*, 174 F.3d 282 (2nd Cir. 1999).

[9]*Ramey v. Reinertson*, 268 F.3d 955, 959 (10th Cir. 2001).

[10]Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, S 13208, 107 Stat. 312 (1993).

[11]Colo. Code Regs. § 2505-10:8.100.7.F (2015).

[12]Colo. Rev. Stat. § 24-51-212 (2015).

[13]S.B. 097, 2015 Leg., 70th Sess. (Co. 2015).

NAPPA Website

By: Brenda Faken

- Did you receive our email dated March 31, 2015, announcing the launch of the new and improved NAPPA website?
- Did you follow the instructions in the email and obtain a password which allows you access to the new functionality of the website?
- After logging in with your new password, did you remember to subscribe to the E-List(s)?

If you answered no to any of these questions, you are missing out on some of the benefits of your NAPPA membership. This is one of the primary ways the Executive Board and NAPPA staff will communicate with you in the future. Step-by-step "How To" instructions are available by clicking on the "Website Help" button on the home page menu bar or see page 19 of *The NAPPA Report*. Learning to use the website and its features will be critical to sending and receiving E-lists as well as viewing invoices and payment receipts.

If you have visited us at www.nappa.org, you probably noticed the new, fresh look of our website. Besides the new look, it also has some new exciting features and functionality. New features of the website include:

- New mobile responsive website – designed to work on all types of mobile devices and still look great.
- Increased security provided by individual usernames and passwords
- Website "How To" instructions to assist you with the new functionality.
- E-list capabilities (similar to the old listserve) but with search capabilities for the new submissions. You **MUST** subscribe to the E-list(s) to be able to send and receive the emails.
- My NAPPA portal – where members can update profile information and their areas of expertise.
- Membership Directory with additional search capability (by name, state, expertise, organization). This functionality is available after you've logged in to the member's only portion of the website.

Coming Soon: For members serving on a committee, we hope to soon release information on how to use the Committee Management module. It will provide a place where committee members can communicate with each other and share files all within the new website. Membership applications and membership renewal will also soon be handled electronically on the website.

If you have any questions or suggestions, please be sure to give us a call. Remember, portions of the website are still under construction, so check back frequently for new content.

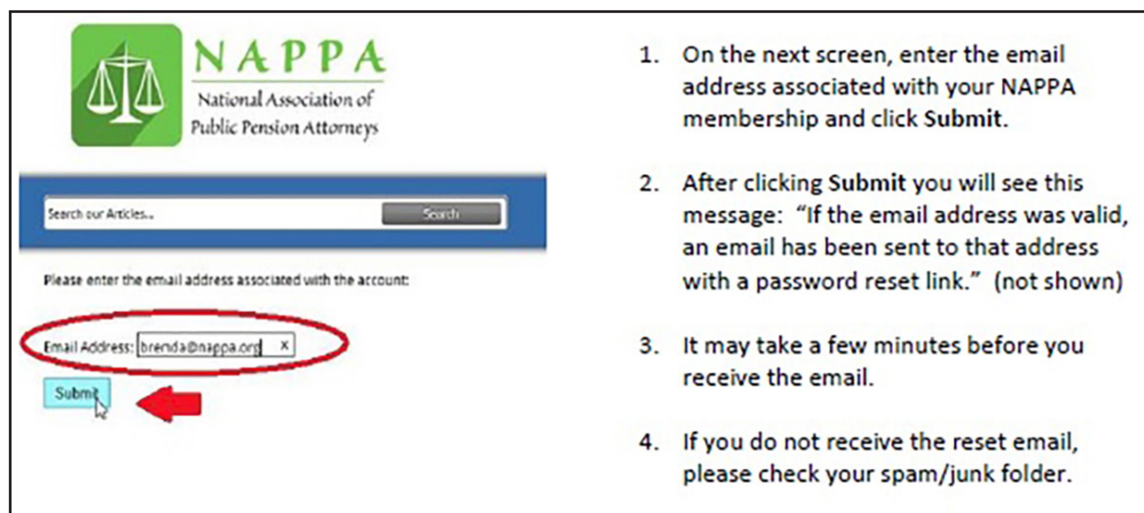
Logging in to the New NAPPA Website!

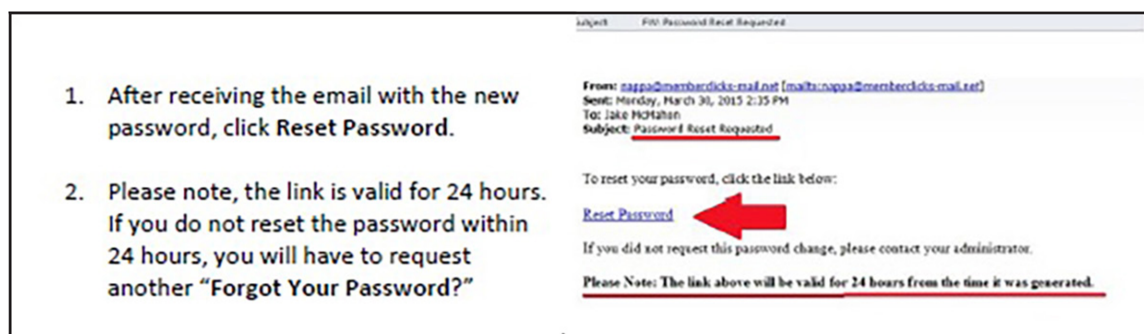
By: Brenda Faken

Username and Password

Each member will now have his/her own unique Username and Password for accessing the website. Privacy standards do not allow for a member's password to be emailed to them. To get started you will need to go through the "Forgot you Password?" instructions below.

Forgot your password? Here's how to set (or recover) your password.





Logging in to the New NAPPA Website! (continued)

To update your password, enter and confirm your new password below. Press submit to send the update.

New password:

Confirm Password:

Passwords match!

Submit

1. Type your new password. (There are no strict requirements for the password other than it cannot be blank.)
2. Confirm password.
3. Submit.

1. After a successful reset, you will be directed back to the NAPPA home page.
2. Enter your **Username** and **Password**.
3. Click **Login**.

Website Help | Contact Us

Username: bfaken | Password

Keep me logged in | Login

Search our Membership... | Search

1. When you see "Hello My Name Is..." you have successfully logged in!
2. You have arrived at the "Member Landing Page."

FEATURES

- My Profile info (red circle)
- Quick Links (blue circle)
- Logout (purple circle
- Find more "How To's" under **Website Help**.

NAPPA National Association of Public Pension Attorneys

MEMBER LOGOUT

HELLO my name is Brenda Faken

Welcome to MyNAPPA!

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