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When Needed Public Pension Reforms Fail or Appear to Be Legally Impossible, What Then?

Are Unbalanced Budgets, Deficits and Governmental Collapse the Only Answer?

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I. Shortcomings of Current Methods of Dealing with Unaffordable and Unsustainable Public Pensions and OPEB Obligations

A. State and Local Government Pension Funds Status:

1. Approximately 4,000 public sector retirement systems for state and local governments in the United States with \$3.8 trillion in assets, 14.4 million current employees, 9 million retirees and annual aggregate benefit distributions of \$228.5 billion.
2. The amount of pension underfunding for states and local governments is estimated to range between \$1 to \$3 trillion.
3. This unfunded liability for pensions can be compared to the estimated FY2016 revenue of \$3.3 trillion for state and local governments.
4. In a recent national survey of 168 leading state and local government credit analysts, they were asked “What do you think are the five most important issues/trends facing the municipal bond market right now [March 2018].” Ninety-two percent responded, “public pension funding levels, pension obligation bonds.” See PNC, U.S. Municipal Bond Market, Municipal Bond Analyst Survey 2018 (April 5, 2018), Thomas Kozik.

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5. Public Pension Benefits from Gratuities to Contractual Obligations.
6. Changes in Demographics of Public Workers. Over the Last 60 Years Added to the Pension Underfunding Problem: the Dynamic of Longer Lifespans and Lower Retirement Ages.
7. Economic Downturns and the Need to Balance the Budgets Contributed to Deferred Pension Funding and Increasing Benefits to Make Up for Delayed Funding.
8. Recent Pension Reform and Litigation:
 - a) Between 2010 and 2015, over 45 states have addressed pension reform. To date, since 2011, there have been over 26 major state or federal state court decisions dealing with pension reforms by state and local governments.
 - b) Seventy-five percent (75%) (20 out of 26) of those decisions affirmed the pension reform, which covered reduction of benefits, including cost of living adjustments (“COLA”), increase of employee contributions, plan conversions and other necessary reforms, many times citing the higher public purpose of assuring funds for essential governmental services and infrastructure.

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- c) Of the four states that did not approve the pension reform, two states, Oregon and Montana, cited the failure of the proponents of reform to prove a balancing of equities in favor of reform for a higher public purpose.
 - d) Another state, Arizona, included state court judges in the reform, which violated another of that state's constitutional provisions about improper influence over judicial officers during service.
 - e) The recent Illinois Supreme Court rulings appear to stand singularly against pension reform for a higher public purpose or as a reasonable effort to save an insolvent pension system.
9. Examples of Recent Pension Reforms and Pension Reform Litigation:
- a) California: California's Pension Reform of 2012.
 - b) Rhode Island: COLA suspension and created hybrid plan.
 - c) COLA Litigation: Maine, Minnesota, New Jersey, Rhode Island, South Dakota, Colorado and others. The Arizona Supreme Court case.

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- d) Illinois Pension Reform Declared Unconstitutional:
 - Illinois pension reform legislation enacted in 2013, providing a claimed \$160 billion in savings over a 30-year period, was struck down by the Illinois Supreme Court as unconstitutional in the case of *In re Pension Reform Litigation* (Ill. Supreme Court, May 8, 2015, hereinafter “*Illinois State Pension Reform Case*”).
- e) Chicago Pension Reform Denied:
 - City of Chicago Labor Pension Reform litigation involving public laborers and workers (Ill. Supreme Court, March 24, 2016, hereinafter “*City of Chicago Pension Reform Case*”) resulted in the Illinois Supreme Court ruling that the reforms were unconstitutional as a violation of Pension Protection Clause for the reasons set forth in the Illinois State Pension Reform case.
- f) San Jose and San Diego Attempts.
- g) Arizona Public Safety Workers Constitutional Amendment.

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- h) Marin and Alameda County Appeals to the California Supreme Court and the Los Angeles Employees Appellate Case holding that “While a public employee does have a ‘vested right’ to a pension, that is only a ‘reasonable pension – not an immutable entitlement to the most optimal formula of calculating pension and the legislature may, prior to the employee’s retirement, alter the formula thereby reducing the anticipated pension. So long as the legislature’s modifications do not deprive the employee of a ‘reasonable’ pension there is no constitutional violation.”
- 10. Involuntary Modification of Public Pensions Outside of Chapter 9 Bankruptcy Is Difficult—(About half the states do not authorize their municipalities to file Chapter 9).
- 11. Many State and Local Governments Have No Current Pension Funding Problem or Have Resolved It.
- 12. Survival of the State or Local Government Is Key to Long-term Survival and Funding of Pensions.

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B. The Unplanned, Free Fall Chapter 9.

1. Chapter 9 courts have authorized the modification of pension obligations (Vallejo, Detroit, Stockton, etc.).
2. Twenty-four (24) states authorize municipalities to file Chapter 9, twelve (12) as decided solely by the municipality and another twelve (12) only after approval by state governor, treasurer, or other elected official or state agency or state approved process.
3. Only 680 Chapter 9 cases since 1957, for the most part without any prior extensive planning or effort to resolve financial difficulties or agreements with creditor constituencies. This is generally referred to as a “free fall” filing of Chapter 9.

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C. Treatment of Public Pension Obligations in Chapter 9.

1. The Vallejo Experience:

- Court recognized that labor agreements can be rejected in Chapter 9 and modifications can be made.

2. The Stockton Experience:

- Court recognized that pension contract could be modified in Chapter 9 assuming the municipality desires to modify the contract – the Calpers chilling effect.

3. The Detroit Experience:

- Following Vallejo and Stockton, the court ruled that pension obligations can be impaired in Chapter 9 even if there is a state constitutional provision that provides that pension obligations cannot be impaired or diminished.

II. The Public Pension Problem Is Not So Much an Unwillingness to Pay as an Inability to Pay

- A. No Tolerance for Unwillingness to Pay Those Pension and OPEB Obligations Which are Affordable and Sustainable.**
- B. What Can Be Done When Consensual Pension Reform Effort Fails and Further Reform Appears Legally and Practically Impossible.**

II. The Public Pension Problem Is Not So Much an Unwillingness to Pay as an Inability to Pay

- C. If Needed Pension Reforms Have Failed or Appear to Be Impossible, Does It Mean That Public Pension Contractual Obligations Cannot Be Altered and the State and Various Local Governments Will Suffer Unbalanced Budgets, Deficits and the Inability to Fund Necessary Governmental Services and Infrastructure Improvements? No, that is not necessarily the result.
1. The essential mission of government is to provide needed governmental services and infrastructure improvements at an acceptable level for the health, safety and welfare of its citizens.
 2. The U.S. Supreme Court rulings permit impairment of contracts for a higher public purpose such as modifying public pension contracts for the public health, safety and welfare of citizens and to allow sufficient funds to pay for needed essential services and infrastructure improvements.

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3. There are at least four possible alternatives available to state and local governments who face this serious problem of needed pension reform. These alternatives assume that all traditional pension reform efforts have been explored including raising taxes and reducing expenditures to the extent possible and needed pension plan adjustments and modifications appear to be impossible legally or on a consensual basis. The four alternatives to be considered by the state or local government employees are:
 - (a) **Prepackaged Chapter 9 Plan of Debt Adjustment** (which requires state authorization to file Chapter 9 and about half of the states do not so authorize municipalities to file Chapter 9. However, Chapter 9 authorizing legislation could be introduced either as an **ad hoc** or generally for all municipalities.)

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- (b) Creation of a Special Federal Bankruptcy Court for Insolvent Public Pension Funds (which requires federal legislation to be enacted).
- (c) Government Oversight, Refinance and Debt Adjustment Commission (“GORDAC”) to assist where public pension reform is otherwise legally or practically impossible.
- (d) Model Guidelines for a state constitutional amendment or legislative public pension funding policy for a higher public good. The necessity of pension benefits adjustment for the public safety and welfare in those situations where state constitutions, statutes or case law appear to prohibit any impairment or reduction of pension benefits.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

A. Prepackaged Chapter 9 Plan of Debt Adjustment.

1. For over 25 years, corporations in Chapter 11 have been using a pre-negotiated plan of reorganization done prior to filing for Chapter 11 to expedite the bankruptcy process avoiding the expense, delay and uncertainty of free-fall bankruptcy.
2. Municipalities authorized by their states to file a Chapter 9 could do the same by, prior to filing a Chapter 9, negotiating, soliciting creditor consent to and obtaining favorable creditor class votes for a plan of debt adjustment. After that, a Chapter 9 filing can be accomplished and the time to confirmation of a plan expedited and completed in possibly 3-4 months rather than years.

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B. Creation of a Special Federal Bankruptcy Court for Insolvent State and Local Government Pension Funds.

1. Congress has the power under the Bankruptcy Clause of the U.S. Constitution to pass uniform laws on bankruptcy which could include a special court for public pension funds.
2. This special bankruptcy court would be separate from the present Federal Bankruptcy Courts and staffed with judges and other professionals skilled in government finance, budgeting, public pensions, bankruptcy and workout experience. Criteria for filing would be specific ratio of funding or demonstrated inability by the public employer to be able to fully fund. It could be centrally located in Washington, D.C. or a few locations in the U.S.A.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

3. Federal legislation would preempt any other laws and give exclusive jurisdiction to the Special Bankruptcy Court.
4. A plan of adjustment would be proposed by the public employer's governmental body as to what is affordable and sustainable paying as much of the pension obligation as reasonably possible. The plan would be subject to objections of the pension fund, public workers and unions and other interested parties.
5. The public pension bankruptcy court would determine if the plan of adjustment is affordable, sustainable and in the best interest of the pension fund and its beneficiaries (workers or retirees) as well as other parties in interest, citizens and taxpayers of the public employer. The plan of adjustment must assure that essential governmental services and needed infrastructure improvement will be timely funded at an acceptable level.
6. This plan process could be done as a prepackaged plan process or through use of mediation during the public pension fund bankruptcy process.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

C. Government Oversight, Refinancing and Debt Adjustment Commission ("GORDAC") to Assist Where Public Pension Reform is Otherwise Legally or Practically Impossible.

1. This is a variation of the two approaches above, prepackaged Chapter 9 and Federal Public Pension Fund Bankruptcy Court. State legislation would create a state commission that would help facilitate voluntary agreement but would have the ability as a quasi judicial body to decide pension issues and bind all parties through a prepackaged Chapter 9.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

2. GORDAC would be comprised of at least three commissioners and professional staff experienced in finance, government, accounting, employee benefit and financial restructuring. One commissioner would supervise the **mediation and voluntary resolution process**, another would be overseeing **transparency of information, discovery and relevant financial disclosure and information** exchange and another commissioner would be the chief judge to **preside over hearing and quasi judicial determination by the commission**.
3. There would be three phases to GORDAC. The first phase would be to determine **the extent of the financial problem (willingness to pay or inability to pay) should taxes and contribution by the employer be raised or should employer contribution and benefits be modified** given realistic projection of revenues and expenses of government and availability of funds to pay pension obligations. **Voluntary resolution and mediation is encouraged** in this phase. If voluntary resolution is not successful the second phase may be requested and, under specified criteria, may be mandatory, namely a quasi judicial determination of what can be paid and what cannot and the appropriate modification of contributions and benefits.

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4. The second phase, quasi judicial determination, is based on the recovery plan of the municipality and its proposal for payments subject to objection by creditors, taxpayers, workers, unions and retirees recognizing funding for essential services and needed infrastructure improvements at an acceptable level is required and the recovery plan must be feasible, and in the best interest of creditors, public workers, taxpayers and pension beneficiaries in that all that can be paid will be paid to creditors and pension beneficiaries without sacrificing the health, safety and welfare of the citizens or the financial survival of the government.
5. The interested parties can be fully informed in a disclosure statement as to the recovery plan and vote on the plan of recovery as approved by GORDAC (with possible modifications by GORDAC as it deems appropriate). The plan can then be implemented, if necessary, as a prepackaged plan in Chapter 9.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

D. Model Guidelines for a Constitutional Amendment or Legislative Public Pension Funding Policy Where State Constitutional and Statutory Provisions and Court Rulings Appear to Prohibit or Impair Needed Pension Reform:

MODEL GUIDELINES FOR A CONSTITUTIONAL AMENDMENT OR LEGISLATIVE FUNDING POLICY TO PREVENT A PUBLIC PENSION CRISIS

1. ***Balanced Budget.*** Balanced Operating Budget for Governmental Entity for the fiscal year where all expenses and liabilities that are due and payable do not exceed anticipated revenues of the Governmental Entity (“*Balanced Budget*”).

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

2. ***Pay Annually the ADC.*** The Governmental Entity shall pay in each and every fiscal year the actuarially determined contribution (“ADC”)* it is liable for under its pension or retirement system (“*Pension Benefits*”) for that fiscal year provided the effect of any modification or reduction of pension benefits required by these Guidelines or determined by its legislative body are included in such calculations. The state may from time to time enact standards and accepted reasonable assumptions to be used in calculating the ADC.
3. ***Reasonable and Necessary Modification Permitted.*** Reasonable modification and reduction of Pension Benefits of the Governmental Entity shall be permitted that are necessary for a higher important public purpose of fully funding and providing for essential governmental services at an acceptable level including needed infrastructure and capital improvements (“*Governmental Services*”) as determined in good faith by the Governmental Entity’s legislative body or its equivalent (“*Legislative Body*”). Again, the state may from time to time enact standards or further guidelines for what is sustainable and affordable and an acceptable level of Governmental Services.

* The actuarially determined contribution (“ADC”) as defined by GASB No. 67 is the fractional equivalent of and replaces the Annual Required Contribution as defined by GASB No. 25.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

4. ***Fully Funding of Governmental Services at Acceptable Level.*** The Governmental Entity's Legislative Body shall in good faith determine the amount of full funding of Governmental Services at the acceptable level required for the welfare of its citizens and the appropriate operation of its government.
5. ***Reasonableness of Modification of Public Pension Benefits in Relation to Governmental Entity's Ability to Fully Fund and Afford Governmental Services and Pension Benefits.*** The Governmental Entity's Legislative Body shall make a good faith determination of the reasonableness of any modification or reduction of Pension Benefits in relation to the Governmental Entity's ability to fully fund and provide Governmental Services and afford and fund actuarially determined Pension Benefits as well as maintain a Balanced Budget for the current fiscal year and the foreseeable future. The inability to do so requires the reasonable modification or reduction of Pension Benefits to that which is affordable and sustainable in the good faith determination of the Legislative Body consistent with these Model Guidelines.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

6. ***Priority of Public Pension Modifications So That to the Extent Possible Any Modification Will Be First Made to Unearned Future Benefits and Any Impairment of Vested Rights Would Be Subject to a Court Validation Process.*** Any required modification or reduction of Public Pension Benefits may be for Pension Benefits to be earned prior to or after the effective date of the modification or reduction with the priority that any modification or reduction first be made to the extent reasonably possible to Pension Benefits to be earned in the future. Any modification or reduction of Pension Benefits earned shall be effective only after a court validation proceeding that confirms the need for the modification or reduction of Pension Benefits in accordance with the Model Guidelines and permitted impairment of contractual rights for a higher public purpose. The Governmental Entity may also seek a court validation of any reduction or modification of Pension Benefits including Pension Benefits to be earned in the future. This court validation process would follow a statutory procedure similar to bond validation proceedings where the court will validate the reduction or modification after a petition by the Governmental Entity and a hearing with notice to affected parties who have an opportunity to appear, determining the modifications and reductions are permitted for a higher public purpose pursuant to these Model Guidelines and required actions and legislative findings have been made.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

7. ***Public Pension Benefits Should Be Affordable and Sustainable by the Governmental Entity.*** The Legislative Body, in any increase in public Pension Benefits to be granted by a Governmental Entity, should determine consistent with the Model Guideline that any increase in benefits is affordable and sustainable by the Governmental Entity.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

8. ***Additional Legislative Findings for Any Modification of Pension Benefits.*** Legislative findings, in addition to those legislative findings and determination as noted above, would generally consist of:
 - (a) ***Existence of Governmental Emergency.*** A governmental emergency exists or will occur in the foreseeable future that will adversely affect the health, safety and welfare of its citizens and the Governmental Entity's ability to fully fund and provide Governmental Services. Any further increase in taxes and any further reduction in expenditures are in the good faith judgment of the Legislative Body unreasonable and contrary to the interest of citizens and tax payers as well as contrary to financially responsible government.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

- (b) ***Modifications Are Mandated for the Public Good.*** Any modification or reduction of Pension Benefits by the Legislative Body are required in the exercise of its governmental powers in order for the Governmental Entity to be able to fund and provide Governmental Services for the higher public purpose of the health, safety and welfare of its citizens.

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- (c) ***Any Modification Is Reasonable in Relation to the Governmental Emergency and the Extent of Any Impairment with Pension Benefits Paid to the Fullest Extent Possible.*** A modification or reduction of Pension Benefits is appropriate and reasonable in relation to the governmental emergency and adverse effects set forth in the legislative finding and the extent of any impairment of Pension Benefits. Pension Benefits should be funded to the fullest extent possible and paid without modification or reduction so long as no governmental emergency exists and there is full funding of and provision for Governmental Services as mandated by the enactment of the Model Guidelines.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

- (d) ***The Harm to Pension Beneficiaries Due to a Modification Is Outweighed by the Harm Suffered by the Governmental Entity and the Citizens.*** The harm caused by any modification or reduction of Pension Benefits to the beneficiaries pursuant to these Model Guidelines is, in the reasonable judgment of the Legislative Body, the least required under these Guidelines and is outweighed by the harm to be suffered by the Governmental Entity and its citizens if such modification or reduction of Pension Benefits required hereunder is not made to address the governmental emergency and the lack of funding for providing Governmental Services to its citizens.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

- (e) ***The Financial Credibility of the Governmental Entity Preserved.*** In the reasonable judgment of the Legislative Body, its financial credibility and access to the credit markets are encouraged by any Legislative Body's action hereunder and are not adversely affected or limited by any modification and reduction to such Pension Benefits required hereunder.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

9. ***Any Modification or Reduction of Pension Benefits Pursuant to These Principles Is Not Considered an Impairment or Diminishment.*** Any modification or reduction of Pension Benefits in compliance with these Model Guidelines hereunder shall not be considered under applicable state constitution, statutes and court rulings to be an impairment or diminishment of the contractual right to Pension Benefits because such Pension Benefits could not realistically be paid by the Governmental Entity due to limited financial resources and the Governmental Entity could not at the same time pay the Pension Benefits without such modification or reduction and fulfill its primary mission of fully funding provisions for Governmental Services along with its financial survival.

III. Possible Approaches When Pension Reform Efforts Fail or Appear to be Legally Impossible

- E. If No Constitutional Amendment Pursuant to the Model Guidelines Is Possible, Then the Proposed Model Guidelines Can Be Adopted by Governmental Entities as a Statement of Public Pension Funding Policy and Enforced Through Litigation, If Necessary.**
- F. In the Long Run, Public Education of the Extent and Seriousness of the Crisis Must Be Accomplished.**
- G. Precise Public Pension Reform under the Model Guidelines and Corresponding Public Pension Policy Is Left to Each Governmental Entity to Decide for Itself Given Its Unique Circumstances.**

IV. **Legal Justification for Permitted Impairment of Contractual Public Pension Rights for a Higher Public Purpose Namely States and Local Governments Cannot Abdicate Their Inalienable Governmental Power to Provide Essential Governmental Services for the Citizens**

A. **The Contract Clause of the United States Constitution Does Not Prevent the Exercise of Police Power:**

1. **In a Government Contractual Relationship, the Government Does Not Surrender Essential Governmental Powers:** For nearly 200 years, the United States Supreme Court has held that **legislatures lack the power to “surrende[r] an essential attribute of [their] sovereignty” or “bargain away the police power of a State”** *U.S. Trust Co. of N. Y. v. New Jersey*, 431 U.S. 1, 23 (1977) (quoting *Stone v. Mississippi*, 101 U.S. 814, 817 (1880)). As the U.S. Supreme Court explained in *Butchers’ Union Slaughter-House & Live-Stock Landing Co. v. Crescent City Live-Stock Landing & Slaughter-House Co.*, 111 U.S. 746, 751 (1884), “[t]he preservation of [the public health and morals] is so necessary to the best interests of social organization, that **a wise policy forbids the legislative body to divest itself of the power to enact laws for the preservation of health** and the repression of crime.”
2. **The Police Power Is Paramount to any Contractual Rights and the Implied Reservation of the Rights of Government.**

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B. The United States Supreme Court Recognizes Balancing of Interests as Applied to the Contract Clause:

1. *Homebuilding & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934) (“*Blaisdell*”), the United States Supreme Court upheld the Minnesota Mortgage Foreclosure Moratorium Law as a valid exercise of the police power, noting that the constitutional protection against the abrogation of contracts was qualified by the authority the state possesses to safeguard the vital interests of its people and that the legislature cannot bargain away the public health or the public morals.
2. Further, the economic interests of the state may justify the exercise of its continuing and dominant protective power notwithstanding any interference with contracts.

IV. Legal Justification for Permitted Impairment of Contractual Public Pension Rights for a Higher Public Purpose Namely States and Local Governments Cannot Abdicate Their Inalienable Governmental Power to Provide Essential Governmental Services for the Citizens

3. Importantly for this analysis, the *Blaisdell* court noted that there needs to be a *rational compromise* between individual rights and the public welfare. It articulated the conditions that justify interference with contractual rights, including: (1) an emergency is present, (2) the legislation is addressed to a legitimate end, (3) the relief afforded is of a character appropriate to the emergency and (4) the conditions do not appear to be unreasonable. *Id.* at 444.
4. **U.S. Supreme Court Cases Support Impairment of Pension Benefits for a Higher Public Purpose – General Welfare of Citizens:** The wisdom of the above-cited United States Supreme Court case should reinforce the appropriate interpretation of the Pension Protection Clauses and statutes that unaffordable pension benefits whose funding would interfere with the appropriate funding of governmental services and infrastructure must be reasonably adjusted for the sake of all concerned.

VI. Conclusion

- A. If pension reform efforts under current state law have failed and state constitutional and statutory provisions are obstacles to any needed pension reform efforts, the answer should not and cannot be that the government reduces funding for essential governmental services, services decline to unacceptable levels, the government melts financially and corporate and individual taxpayers leave.
- B. If public pension funding issues are an unwillingness to pay from a government that has the ability to pay, then the government must step-up and fund the underfunded pension obligation.

VI. Conclusion

- C. If the government has the inability, financially, to pay the underfunded public pension obligations, and it attempts a voluntary or negotiated needed pension reform that has failed or appears impossible due to state Constitutional Pension Protection Clauses or statute and court rulings, then, specifically the Prepackaged Chapter 9 Public Pension Fund Bankruptcy Court, Government Oversight, Refinancing, and Debt Adjustment Commission or Model Guidelines for a constitutional amendment or a legislative public pension funding policy should be considered to address or resolve the public pension issues. (This assumes that taxes have been raised to the fullest extent legally possible or prudent, and the expenses have been reduced to the extent reasonably practical.)

VI. Conclusion

- D. The answer should never be that the needed public pension reforms have failed or appear impossible so the government itself fails and all parties suffer the worst outcome possible.

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