

SDCERS NAVIGANT REPORT COMMITTEE/STAKEHOLDER MEETING

March 8, 2006 - Meeting Notes by Virginia Silverman

INTRODUCTION/PRELIMINARY

Committee members in attendance: Mark Sullivan (Chair), Thomas Hebrank, William Sheffler, Richard Kipperman. Other SDCERS Board members in attendance: Peter Prevolos, Joe Flynn. (Many City Officials in the audience, including CFO, Jay Goldstone, City Auditor John Torrell, Representative for Council President Scott Peters, and Don McGrath, City Attorney's Office.

Mark Sullivan stated the objective of this meeting: to protect the assets of the SDCERS trust fund in the event of a City Bankruptcy. He said SDCERS duty is to be knowledgeable and prepared, that the elephant in the room cannot be ignored, and that it is being addressed early in this series of meetings for that reason.

Sullivan announced a change in today's meeting schedule, with public comment scheduled after the presentation to permit more informed comment.

NON AGENDA PUBLIC COMMENT

Jay Goldstone, City of SD Chief Financial Officer, stated that the City is in the middle of preparation of the FY 2007 budget. He is waiting for the valuation from SDCERS, but so far there has been no recommendation from the Mayor for bankruptcy. However, Goldstone said there may be budget cuts.

1.A.1 - PRESENTATION:OVERVIEW OF CHAPTER 9 BANKRUPTCY LAW

The presentation was made by Attorney Harvey Leiderman of Steefel, Levitt & Weiss, P.C, a law firm specializing in bankruptcy. Mr. Leiderman was fiduciary counsel for the Orange County Employee Retirement System during the O.C. Bankruptcy, and guided a California Water District through a Chapter 9 bankruptcy.

He said the presentation would address what is required for a municipality to file for bankruptcy; what happens during the bankruptcy case; and how a municipality emerges from bankruptcy. It will not address whether the City can, should, or will file for bankruptcy.

Leiderman began by explaining that Chapter 9 of the Federal Bankruptcy code provides bankruptcy options to municipalities, with the goal of implementing a plan that adjusts the obligations of the municipality while permitting it to continue serving its public purpose. He addressed specific aspects of bankruptcy through a series of questions and answers:

Q1 - Who May File under Chapter 9?

a. Must be a municipality and authorized under state law to be a debtor under federal bankruptcy law (Charter cities in California are so authorized).

b. Must be insolvent, unable to pay debts as they come due. (Note: the definition of insolvent is different for corporations than municipalities. For corporations, the balance sheet determines insolvency, i.e. if liabilities are larger than assets. For municipalities, insolvency is not having sufficient cash flow to pay debts, regardless of assets and liabilities.)

c. Must desire adjustment; and

d. Must obtain OK from majorities of creditors to accept plan, or have negotiated in good faith but still unable to receive OK from creditors (this must have the court's approval)..There are other exceptions, such as for practicality, which can be granted by the court.

Q2 - What Happens During the Bankruptcy?

- a. All pending or potential legal actions against the debtor/municipality or its property are frozen.
- b. The municipality must stop paying its 'pre-petition' (pre-bankruptcy) obligations, unless there is a court order (this is to prevent favoring one debtor over another). These debts are placed in abeyance.
- c. The municipality must continue to perform all contracts necessary for its 'post-petition' operations.
- d. The municipality can use, sell or lease its property in the ordinary course of business, even if the property is subject to liens, but may not use proceeds of a sale without the lienholder's consent or otherwise protect the lienholder's interests.
- e. Any other person holding property of the municipality must turn that property over to the municipality.

Q3 - What Powers Does the Municipality Have Under Chapter 9?

- a. The municipality continues to possess its property and operate its affairs. All elected and appointed officials remain in power. No 'trustee' can be appointed by the court (federal bankruptcy law forbids imposing a trustee on a state (or its political subdivisions??)).
- b. The municipality may hire professionals and pay them as much as it wants.
- c. The municipality may reject 'executory' contracts (an executory contract exists when where there is still something to be performed by both sides, such as a Collective Bargaining contract.)
- d. The municipality can borrow funds on an unsecured basis from any source, and may provide collateral to a new lender, including priority in payment over existing creditors, with the Court's consent.
- e. The municipality may recover pre-petition preferential transfers of property, or transfers made for less than full value (does not include contributions to the retirement fund. (What about transfer of City property to SDCERS in the Gleason settlement?))
- f. The municipality may abandon property it deems of little value or benefit.
- g. The municipality may file suit against others to assert claims in its favor; and may object to claims against it and bring them to trial in Bankruptcy court.
- h. The municipality MAY NOT escape from State legislation and regulation.

Q4 - What is a Plan of Adjustment?

A Plan of Adjustment (Plan) must be filed by the municipality within the time period set by the Court. The Plan lists the various obligations of the debtor/municipality according to the priority of their claims under state and federal law (e.g., priority secured claims, subordinated secured claims, general administrative claims, unsecured trade claims, equity interests).

The Plan must provide a 'treatment' for each class of similar claims as to how that class will be satisfied (e.g., paid in full in cash, paid in full over time with or without interest, granted other property in exchange, etc.)

Along with the Plan, the municipality must issue a 'Disclosure Statement' approved by the Bankruptcy Court. The Disclosure Statement is like a prospectus, detailing history, attempts to restructure its obligations, and the proposed Plan. It also must contain financial performance projections, to provide each creditor sufficient information on which to make an informed decision whether to vote in favor of the plan.

The Disclosure Statement is sent to all parties in interest (creditors). It includes a ballot, permitting each creditor in each class to vote in favor of or against the Plan. If creditors holding at least half of the number of claims in each class and at least 2/3rds of the dollar amounts of claims in each class, vote in favor of the Plan, the Plan can be confirmed. If a class votes against the Plan, the Plan may still be confirmed over their objections, if the Court believe they are being treated fairly. (Comment/Question: Retiree health benefits are set in collective bargaining agreements by the Unions and Management, with no retirees involved. Would we at least have a vote as a 'creditor' for health

benefits?)

Q5 - What Must be in the Plan for the Debtor to Emerge from Bankruptcy?

To be confirmed by the court, the Plan must be in the best interests of creditors and be feasible. ('Best Interest of creditors' means that creditors would fare better under the plan than if the debtor's assets were simply liquidated and distributed to creditors in order of their priorities. 'Feasible' means that the economics of the plan make sense, and it is not likely that the debtor will have to return to bankruptcy, and that the City will be able to continue to provide public services.)

The Plan may also reserve the municipality/debtor's right to contest any creditor's claim or to sue any third party to recover money or for other relief. The Bankruptcy Court frequently retains jurisdiction over these contests.

Q6 - What Happens After Confirmation of the Plan of Adjustment

Upon confirmation of the Plan of Adjustment by the Court, the debtor/municipality is discharged (forgiven) from all debts not provided for under the Plan, or which the Plan provides shall be discharged. After confirmation, the municipality emerges from Chapter 9 as a new entity, with all of the rights and powers established under state law and under the terms of the Plan.

1.A.2.- PRESENTATION OF EFFECT OF POTENTIAL CITY BANKRUPTCY (Q&A)

Harvey Leiderman and representatives from of Seltzer Caplan McMahan Vitek ('Seltzer Caplan') discussed the impact of a City bankruptcy on the retirement system, continuing with the Q & A format.

Q1 - Is San Diego insolvent?

No

Q2 - Could San Diego reject existing collective bargaining agreements that granted increased benefits?

Likely. Limitations on a debtor's ability to reject labor contracts don't apply to municipalities. The Court could apply a less restrictive "balance of equities" to reject the contract.

Q3 - Would SD have to reject the entire collective bargaining agreement or could it pick and choose?

The law requires rejection of the entire agreement, not piecemeal.

Q4 - If City rejected collective bargaining agreements, what would happen to active City employees?

Their unions would have to negotiate new collective bargaining agreements.

Q5 - If City rejected collective bargaining agreements, what would happen to members' retirement benefits?

Benefits granted to those already retired are unlikely to be affected: their contract is not 'executory,' since no further performance is due from them, either service or contributions. For current City employees, the contract is still 'executory.' However, the vested rights protected by the contracts clause of the (State?) Constitution may prevail.

Q6 - May the City stop paying employee contributions into SDCERS while in Chapter 9?

No. Payroll deductions for retirement contributions are not property of the debtor (City) but are collected in trust for SDCERS.

Q7 - May the City stop paying employer contributions into SDCERS while in Chapter 9?

There are strong legal reasons why City may not stop payments - at least for the 'normal cost' portion of the employer contribution (payment of the unfunded actuarial liability might be treated differently). Payments under the Gleason settlement are partially secured by real property, and therefore SDCERS would have rights of a lienholder in bankruptcy.

Q8 - May the City stop the 'pick up' of employee contributions into SDCERS while in Chapter 9?

Not unless the City rejects the collective bargaining agreement that provided for the pick up.

Q9 - Would a City bankruptcy filing affect SDCERS assets or investments?

SDCERS is a governmental entity distinct from the City, and its assets and investments are not commingled with the City. However, if City suspends contributions to SDCERS, cash flow and asset allocation policies would be affected.

Q10 - Could the City seize SDCERS' assets in Chapter 9?

No. SDCERS assets are not property of the City, but held in trust for members and their beneficiaries.

Q11 - How much would a bankruptcy cost taxpayers?

Bankruptcy is expensive! In 1994-96, Orange County bankruptcy fees were over \$100 million, not including investment manager fees. Besides a municipality's own costs for professional services, Chapter 9 also permits interested parties to form committees and hire professionals at the expense of the municipality -- attorneys, financial advisors, investment advisors may all be paid for "substantial contribution" to the case. (Question: Might retirees be able to use this vehicle to pay for legal counsel to protect health benefits and pensions?)

RECOMMENDATIONS TO THE COMMITTEE

Harvey Leiderman recommended the following actions: 1) Prepare an in-depth analysis of bankruptcy impact for further report to the Committee; 2) Advise the Committee and the full SDCERS Board in closed session on legal strategies to preserve SDCERS Board's ability to carry out its Constitutional duties. Improve member and public understanding of a possible City bankruptcy and its likely effect on the retirement system.

(Note: The agenda lists recommendations under New Business, 2.A.1. However, Mr. Leiderman made the above recommendations immediately following the Q&A)

QUESTIONS AND COMMENTS (Committee Members and Public)

Thomas Hebrank: Q. Any impact on SDCERS ability to pay retirees? Any impact on Airport Authority or Port District? A. No to both questions.

Peter Prevolos: Commented that if cash flow stops coming in, it could be necessary to sell existing assets.

Mark Sullivan: commented that SDCERS administers benefits for persons deemed to be eligible, and SDCERS will continue to administer them based on benefit structure from the City.

Prevolos: Q. Would selling off SDCERS assets affect the Port District and Airport Authority? Would only SDCERS assets dedicated to City be affected? Are assets commingled? A. (Leiderman) The answer was unclear, but Leiderman said that there are IRS problems with this arrangement. He said Ice Miller might differ on the interpretation. (Ice Miller is SDCERS tax counsel.)

Virginia Silverman (Retired City Employees Rep.): Q. Health Insurance for City Retirees is decided in collective bargaining negotiations between the City and the unions - retirees have no say in this process. What will happen if City goes into bankruptcy and collective bargaining agreements are abrogated? A. (Leiderman, Prevolos) Can't answer, it is not SDCERS business Sullivan: Health insurance will be discussed at May Navigant Committee meeting.

Dave Wood (Retiree) Q. How would SDCERS Board handle a shortfall in funds -- would they try to stretch it out, pro rate payments, or what? A. SDCERS Board would decide, after hearing, how money should be sent. William Sheffler commented that there is enough income each year (\$320 million) generated by existing assets to completely pay for all benefits at this time.

OTHER DISCUSSION ITEMS

1.A.3 - USE OF CUSTODIAL BANK:

Doug McCalla, Chief Investment Officer, gave a briefing on the State Street Bank, the custodial bank used by SDCERS, its function and SDCERS controls.

1.A.4 - GLEASON SETTLEMENT AND PROPOSITION G

Reg Vitek and Mike Leone from Seltzer Caplan gave a brief presentation on the Gleason Settlement and Proposition G. They said that the primary purpose of Gleason was to return funding to an actuarial structure. Between now and 2008, the City will make contributions based on a 29 year amortization schedule. Each of the three payments is secured by deeds of trust on specific City properties (Qualcomm Stadium parking lot, Sports Arena, Ridgehaven Bldg., etc.) Once a payment is made for the year, specific properties are transferred back to City. SDCERS still holds deeds on properties for the two remaining payments/years. Each block of property is worth more than \$125 million.

Potential Effect of Proposition G - 15 Year Amortization Schedule: Prop. G, passed in November 2004, shortened the payment schedule, and expressly forbids underfunding by City. The question is, does Prop. G 'mandate' that Board must adopt 15 year schedule? If so, it may conflict with State law which grants pension boards the ability to set payment schedules. (The wording of Prop G is "the Board shall adopt a schedule no longer than 15 years. According to the attorneys, the word "shall" strips the board of its fiduciary duties under the State constitution.

2.A.1.- NEW BUSINESS/ RECOMMENDATIONS TO PROTECT TRUST FUND

Recommendations by Leiderman appear after Q&A in these notes.

2.A.2- NEW BUSINESS/ RECOMMENDATION FOR A NEW AUDIT COMMITTEE

This recommendation is to establish a new audit committee, comprised of two current SDCERS Board members and three outside professionals. There was discussion and disagreement as to the specific credentials needed for the three outside professionals. The recommendation was adopted, with modifications.

3.A.1. - OLD BUSINESS / STATUS REPORT ON TAX COMPLIANCE ORDINANCE FOR IRS VOLUNTARY COMPLIANCE PROGRAM

SDCERS staff reported on a conference call with Ice Miller and the IRS, targeting reports to the IRS by April 1st. A meeting was set up with Ice Miller to discuss rollovers, minimum distribution rules, and health benefits. (I raised a question after these comments about the status of proposed technical amendments to City ordinances sent to the City last May, asking if there was any progress. Roxanne Story Parks said SDCERS recently contacted Mayor Sanders on this issue.)

ADJOURNMENT

3:40 p.m. Next meeting will be at 1:00 p.m. on Wednesday, April 12, 2006. Topics for discussion will be Governance and Education and Restoring Funding Level and Actuarial Soundness to SDCERS (specifics topics will include: Reduce UAAL, Entry Age Normal , amortization periods,

eliminate waterfall, reserve accounts)