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Disarming Puerto Rico's Pension Time Bomb

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With the long-delayed commencement of negotiations between the new government of Puerto Rico and its financial creditors finally underway, and the expiration of the existing stay on creditor actions looming, much of the financial press' attention over the next several weeks will undoubtedly be focused on whether the government of Puerto Rico can reach an out-of-court settlement with its financial creditors. One issue that has received less attention in the financial press, but which is of paramount importance to a financially secure local economy, is the challenge Puerto Rico confronts in reforming its multiple pension systems. Like many other state and municipal governments, Puerto Rico faces difficult choices regarding how to address the substantial cost and massive underfunding of its public pension systems, calculated by analysts to exceed $48 billion.[1] In the recently certified fiscal plan, the federal oversight board has offered guidance toward both reducing the liabilities of the pension systems and adding structural reforms to improve its ongoing funding. In particular, the oversight board has suggested progressive reductions of aggregate pension outlays by more than 10 percent by fiscal year 2020, funding existing benefits on a pay-go basis and moving existing and all new active members into defined contribution accounts that segregate and protect contributions to pay future benefits.


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While the current administration has expressed reservations regarding these suggested actions, it has agreed to work with the oversight board on a plan to implement pension reform by June 30 of this year. This article identifies the two legal mechanisms available to the commonwealth government to reform its public pension systems — namely, legislative action or implementation of reforms through one or more Title III proceeding(s) under the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA). Focusing on the central government's Employee Retirement System (ERS), which is the largest of the commonwealth's public pension systems, we analyze the key considerations that will undoubtedly influence the decision of how to proceed. Not surprisingly, the more likely that a Title III proceeding will be needed to adjust the commonwealth's tax-supported debt, the more inevitable it is that pension reform will also come from one or more Title III processes rather than through legislative measures.

ERS, Historical Reform Efforts and Pensions Under Puerto Rico's Constitution

ERS is a statutory trust created to provide pension and other post-employment benefits (OPEB) to former employees of the commonwealth itself, as well as to former employees of more than 200 other governmental employers, including central government agencies, as well as public corporations and municipalities.[2] Aside from the proceeds of bond issuances, ERS is funded primarily by contributions from participating employers (the "employer contributions") and participating employees (the "employee contributions"). Nevertheless, ERS is catastrophically underfunded, and its net assets were exhausted as of fiscal year 2014-2015.[3]

To be sure, the commonwealth has the ability to enact legislative measures to reform its pension systems. Indeed, like many other governments and municipalities facing fiscal difficulties relating to pension obligations,[4] the commonwealth has previously undertaken various reform measures aimed at increasing the employer and employee contributions, most notably under the previous García Padilla administration. However, such reforms met with mixed results. The growing fiscal crisis gripping the commonwealth made it difficult to marshal additional financial resources to address years of underfunding of the public pensions. Further, judicial decisions held that Puerto Rico's Constitution limits the Legislature's ability to impair vested pension obligations.[5]

Under commonwealth law, pension obligations are generally understood to be contractual obligations that can only be impaired prior to the beneficiary's retirement (if such impairment is reasonable and necessary to further the actuarial solvency of the pension system), as opposed to after retirement.[6] Case law since the onset of Puerto Rico's fiscal crisis has generally upheld this principle. In Trinidad Hernández v. Estado Libre Asociado, 188 D.P.R. 828 (2013), the Supreme Court of Puerto Rico (PRSC) considered the constitutionality, under the contracts clause of Puerto Rico's Constitution, of 2013 reforms to ERS that increased both the employee contributions and the minimum retirement age for participants. In upholding the constitutionality of such reforms, the PRSC found the reforms reasonable in light of the compelling need to (1) guarantee the survival of ERS and prevent credit downgrades for the commonwealth and its instrumentalities and (2) address the fiscal crisis.

However, only several months later, in Asociación de Maestros v. Sistema de Retiro, 190 D.P.R. 854 (2014), the same court considered, also under the contracts clause of Puerto Rico's Constitution, the legality of 2014 reforms to the Teachers' Retirement System (TRS) that largely tracked the analogous reforms to ERS described above, and reached an opposite conclusion. In finding the TRS reforms unconstitutional, the PRSC focused on evidence that the proposed reforms would have in fact incentivized early retirement to retain benefits, thus accelerating the insolvency of the TRS. Accordingly, the PRSC found that the measures were not reasonable and necessary to further the solvency of the TRS.

Regardless of how one interprets the differing PRSC decisions on ERS and TRS reforms, what appears clear is that, as a matter of commonwealth law, while the Legislature can reasonably and necessarily alter the rights and benefits of active employees, it faces significant barriers before it can impair vested benefits for current retirees.

The Commonwealth's Options, Chapter 9 Precedents and Expected Treatment Under Title III

Against the backdrop of PROMESA, the commonwealth is effectively left with two options for modifying its public pensions in accordance with the approved fiscal plan: (1) through legislative measures or (2) through a Title III proceeding under PROMESA.[7] While legislative reforms might be an option, and theoretically could be crafted to adjust each of the island's public pensions systems in one measure, given recent decisions by the PRSC, any such measures will be susceptible to challenge under commonwealth law and will be limited in adjusting vested pension benefits. Instead, the commonwealth and the oversight board may consider a Title III proceeding a more attractive option given the ability of a Title III court to exercise the authority bestowed upon it by the federal Constitution's bankruptcy power to modify even vested benefits. Moreover, there may be strategic reasons unrelated to pension reform that favor effecting pension adjustments through one or more Title III proceedings, not the least of which is the possibility of identifying and securing the support of an impaired class of creditors to assist it in imposing an adjustment plan through the cramdown powers of Section 1129(b) of the Bankruptcy Code.[8]

Historical Treatment of Pensions Under Chapter 9

Although PROMESA is untested, state municipalities have long used Chapter 9 of the Bankruptcy Code to adjust their debts, including pension obligations, in a way that they could not outside of bankruptcy. Importantly, state constitutional protections analogous to those under Puerto Rico's Constitution are generally understood (both by scholars and as interpreted by courts) to be unenforceable in Chapter 9 proceedings pursuant to the federal supremacy clause. The issue of whether pensions can be impaired in Chapter 9 proceedings irrespective of local law protections has been squarely before courts in two recent Chapter 9 cases.

First, in Detroit's Chapter 9 bankruptcy, the court considered whether the contracts clauses of the U.S. and Michigan Constitutions, as well as an additional prohibition against impairing pension benefits under the Michigan Constitution, prevented the impairment of pension benefits as part of a plan of adjustment. In holding that pensions could be impaired in Detroit's Chapter 9 bankruptcy, the court stated emphatically that "[t]he Bankruptcy Clause of the United States Constitution, and the bankruptcy code enacted pursuant thereto, explicitly empower the bankruptcy court to impair contracts and to impair contractual rights relating to accrued vested pension benefits." In re City of Detroit, 504 B.R. 97, 150 (Bankr. E.D. Mich. 2013). Ultimately, notwithstanding the ability to impair its pension claims, Detroit provided substantial recoveries on its pension claims (in substantial part aided by the so-called "grand bargain," which involved contributions made to the system by private third parties). Pensioners who were paid from the general pension system received 95.5 percent of their pensions (though their cost of living adjustment (COLA) was eliminated) and pensioners who were paid from the police and fire pension fund received 100 percent of their pensions (while keeping 45 percent of their COLA). However, both sets of retirees experienced substantial reductions to OPEB.

Second, and more recently, pension impairment issues arose in Stockton, California's Chapter 9 bankruptcy, albeit in a slightly different context. In Stockton's bankruptcy, the California Public Employees Retirement System (CalPERS) argued that its contract with Stockton could not be rejected or impaired, pursuant to protections under California state law. Though raised in a different procedural posture than Detroit, the California court similarly held that the CalPERS contract could be impaired in Stockton's Chapter 9 proceeding, noting that "[t]o honor [prohibition on impairment of CalPERS contracts] would amount to permitting a state to usurp the exclusive power of Congress to legislate uniform laws on the subject of bankruptcy." In re City of Stockton, 526 B.R. 35, 57 (Bankr. E.D. Cal. 2015). Notwithstanding the court's holding in Stockton, the city ultimately chose to assume the CalPERS contract and not impair its pension claims (although as noted below, Stockton retirees also experienced substantial OPEB cuts).

Generally speaking, the approach in Stockton and Detroit of providing high pension recoveries while substantially impairing other claims (including OPEB) is typical in recent large Chapter 9 proceedings.[9] A chart showing pension and OPEB recoveries (and approximate prepetition pension funding amounts) in a few recent major Chapter 9 bankruptcies is set forth here:

	Prepetition pension funding amount	Pension recovery in bankruptcy	Retiree OPEB (i.e., health care) recovery in bankruptcy
Stockton, California	85-90 percent	100 percent	1 percent
Detroit (Police & Fire)	89.3 percent	100 percent of pension; 45 percent of COLA	10-13 percent
Detroit (General)	70 percent	95.5 percent of pension; 0 percent COLA	1 percent
San Bernardino, Calif.	74 percent	100 percent	1 percent

Likely Issues to Arise on the Treatment of Public Pensions in a Title III Proceeding

Generally speaking, the analysis of pension and OPEB claims in a Title III proceeding under PROMESA is the same as under Chapter 9, with one notable exception. PROMESA provides that any approved fiscal plan must, inter alia, "provide adequate funding for public pension systems" and in turn provides that any approved plan of adjustment must be "consistent with the applicable Fiscal Plan certified by the Oversight Board." See PROMESA §§ 201(b)(1)(C), 314(b)(7).[10] The text and legislative record regarding this language creates some ambiguity over the meaning of "adequate funding for public pension systems," but given the oversight board's certification of the commonwealth's fiscal plan and its suggestions to reform the government's public pension systems, the oversight board seems to have interpreted "adequate funding" to simply mean that the budget must reflect adequate funding for the pensions on the terms set forth in the approved fiscal plan. Notwithstanding that PROMESA states that "[t]here shall be no jurisdiction in any United States district court to review challenges to the Oversight Board's certification determinations under this Act," see PROMESA § 106(e), certain representatives of pensioners have sought to challenge the fiscal plan as certified on the basis of its treatment of pension claims.[11]

The existing clear authority in various Chapter 9 cases overriding state constitutional limitations to adjust pension obligations will clearly be an important factor when the commonwealth considers how to effect pension reform in Puerto Rico. However, using Title III does have some drawbacks. First, it presupposes the use of Title III itself, something that both the oversight board and the current administration in San Juan have stated they wish to avoid if at all possible. Second, it seems clear that not all pension systems could be modified as part of one proceeding. For example, PREPA's pension plan, which is a defined benefit plan and provides greater benefits to retirees than other public pension plans in Puerto Rico, could only be modified in Title III as part of a Title III proceeding for PREPA (something the administration and PREPA creditors have steadfastly sought to avoid).[12] Third, the practical ability to modify pension obligations as part of a Title III proceeding will depend upon the facts and circumstances of each Title III proceeding and thus may be difficult to predict or control. Ultimately, however, as it seems likely that the commonwealth will need to resort to Title III to address its tax-supported debt,[13] we expect that the commonwealth will employ Title III to adjust the pension obligations of the central government rather than use legislative channels.

Adjusting ERS Obligations as Part of a Title III Plan

What would a Title III proceeding seeking to modify ERS pension obligations look like? Although it is clear that ERS pension obligations could be modified in a Title III proceeding, difficult strategic choices and various complexities will invariably arise.

First, as a threshold matter, the oversight board and the commonwealth will need to determine whether to modify ERS pension obligations as part of a stand-alone ERS Title III proceeding or as part of a commonwealth-wide plan to address all tax-supported debt and the pension and other obligations of all central government public pension systems (or at least those included in the certified fiscal plan). The fiscal plan that has been certified by the oversight board would seem to permit either choice. However, given the limited number of potential classes of creditors at ERS, the oversight board and the commonwealth may determine they are better off seeking to adjust ERS pension obligations in a jointly administered proceeding to adjust central government liabilities and functions. Because ERS does not itself have operations that would give rise to a broad swath of trade, employee and other creditors, whose claims could represent an impaired accepting class at ERS itself, the commonwealth may seek to look to creditors of other issuers within a joint plan to find an impaired accepting class to permit a nonconsensual cramdown under Section 1129(b). The oversight board and the commonwealth could, as part of a joint plan, seek to find creditors willing to be an impaired accepting class among creditors of other issuers whose debt is reflected in the certified commonwealth fiscal plan. In addition, as not all courts have held that such "jointly administered" creditor votes at another debtor qualify as an impaired accepting class, the commonwealth may seek to substantively consolidate ERS with other commonwealth debtors. The availability of these remedies will not only be hotly contested, but will put pressure on undersecured ERS bondholders to avoid a cramdown scenario.[14]

Second, complicated issues could arise with respect to ERS' ability to (and the extent to which it can) impair its bondholders in a Title III proceeding (and thus divert more recoveries to pension claimants). While ERS bondholders may have a lien on the employer contributions and certain other collateral,[15] ultimately the extent to which ERS bondholders can be impaired will be a function of whether (to the extent they are secured at all) ERS bondholders are secured through a statutory lien or their collateral constitutes special revenues. Indeed, as the statutory language authorizing the ERS to issue bonds does not contain any lien-creating language, very good arguments exist that ERS bondholders do not have a statutory lien. See 3 L.P.R.A. § 779(d).

Moreover, although a slightly more difficult question on the margins, strong arguments also exist that the employer contributions are not special revenues, because the employer contributions are not system or project revenues of the ERS in the same sense that, for example, toll revenues are of the Puerto Rico Highways and Transportation Authority. See 11 U.S.C. § 902(2). While ERS operates a "pension system," it is difficult to argue this constitutes the type of system "primarily used or intended to be used primarily ... to provide ... services" that Congress intended to fall within the scope of Section 902(2). If ERS bondholders have neither a statutory lien nor special revenues collateral, the liens of ERS bondholders will not continue post-filing, and ERS bondholders may be more inclined to reach an overall consensual deal in order to avoid having the unsecured portion of their claims substantially impaired.[16]

Third, ERS' status as a trust could also present complicated issues if ERS does not file for a Title III proceeding prior to the time that the Title IV stay under PROMESA expires (May 1, 2017 unless extended).[17] Under Puerto Rico trust law, the ERS trustee can bring actions against employers to enforce the terms of the trust, and where the ERS trustee does not do so, employees may have such rights as well under the terms of the applicable collective bargaining agreements.[18] If a gap exists between the end of the Title IV stay and the beginning of the Title III stay, there may be a proliferation of lawsuits against various defendants, some of whom may already be or ultimately will be Title III debtors, and some of whom may not.[19]

Fourth, as a general consideration, the complications in any of the scenarios discussed above may be further exacerbated if a single retiree worked for multiple employers (some of which may be ERS contributors, some of which may be Title III debtors, and others of which may not). The multiple employer issue may be particularly complicated at the plan confirmation stage if releases cannot be extended to nondebtor third parties. Indeed, bankruptcy courts have split on whether and under what circumstances nondebtors can be released as part of a plan of reorganization in the Chapter 11 context, and even those circuits that have restricted third-party releases in Chapter 11 plans acknowledge that the analysis differs under Chapter 9.[20] We are not aware of any Chapter 9 court to have considered this issue in the context of pension beneficiaries' claims against municipal employers, and inclusion of such release in a proposed plan of adjustment will certainly provide fodder for litigation.

Conclusion

The more likely it is that a Title III proceeding will take place in order to adjust the commonwealth's tax-supported debt, the more likely it is that Title III will also be the mechanism by which Puerto Rico will adjust its public pension obligations as provided for in the certified fiscal plan. Though Puerto Rico's public pension systems are exceedingly complex and a Title III adjustment to Puerto Rico's public pensions will raise novel legal issues, Title III is likely the best option available to the commonwealth to adjust its public pension obligations as part of the larger effort to address its current fiscal crisis. Through a Title III proceeding, pension and other retirement benefits (vested and unvested) can be adjusted to reflect the commonwealth's economic realities, and appropriate structural changes can be made to pension systems to ensure their continued viability. It may also be possible as part of a Title III adjustment plan to identify assets that can be contributed to public pension systems in order to improve their long-term viability, such as interests in public entities that are expected to be privatized (or even to issue growth bonds or contingent value rights to such systems that could ultimately help fund future incremental benefits). Further, there may be strategic reasons to seek to impair pension benefits as part of a Title III proceeding as it may provide the commonwealth and the oversight board with leverage over certain financial creditors as it negotiates a broader Title III adjustment plan. Ultimately, how Puerto Rico's pension crisis is addressed may have wider repercussions as well, serving as a possible blueprint to other municipalities that may themselves be struggling with similar fiscal reform and pension challenges. Whatever path Puerto Rico takes, you can be sure that other municipalities will be paying close attention.

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DISCLOSURE: Cleary Gottlieb assisted the commonwealth of Puerto Rico and its instrumentalities with their financial challenges prior to the recent change in government. The firm also currently represents the Government Development Bank for Puerto Rico on a legacy matter.

This article is the fourth installment of a series on the Puerto Rico debt crisis. Read the first article here, the second article here and the third article here.

[1] Figure is in USD and includes net estimated pension liabilities as of June 30, 2015, for the three public pensions included in the fiscal plan: the Employee Retirement System (ERS), the Teachers' Retirement System (TRS) and the Judiciary Retirement System (JRS). See Government Development Bank for Puerto Rico, Commonwealth of Puerto Rico Financial Information and Operating Data Report at 17 (Dec. 18, 2016). Because the commonwealth report has not been updated, more recent figures as calculated by the commonwealth and its actuaries are not available.

[2] As noted above, the approved fiscal plan includes three of Puerto Rico's public pension systems: ERS, TRS and JRS. The commonwealth also has two other public retirement systems — the Electric and Power Authority Retirement System (for PREPA) and the University of Puerto Rico Retirement System. To date, the restructuring support agreement negotiated by PREPA and its financial creditors has not required modifications to PREPA's pension plan, which is significantly underfunded (though substantially less underfunded than the ERS).

[3] See Milliman Inc., Puerto Rico Government Employees Retirement System: Actuarial Valuation Report at 14 (June 30, 2014).

[4] Growing concerns over pension obligations are not unique to the commonwealth. Over the last several years, state courts have weighed in on proposed pension reforms, sometimes with different results. For example, the New Jersey Supreme Court has twice upheld proposed pension reforms that impair benefits. See Burgos v. State of New Jersey, 222 N.J. 175 (2015) (state not contractually obligated to fund pensions on legislatively established contribution schedule because promise to do so was in violation of the New Jersey Constitution's debt limitation and appropriations clause); Berg v. Christie, 225 N.J. 245 (2016) (suspension of COLAs did not constitute contracts clause violation because the state Legislature did not unequivocally create right to COLAs). In contrast, the Supreme Court of Illinois recently held that certain proposed pension reforms were unconstitutional based on Illinois state constitutional protections for pensions. See Jones v. Mun. Emps.' Annuity & Benefit Fund, 2016 Ill. 119618 (2016).

[5] Following the appointment of the oversight board, the ability to enact legislative measures to address the commonwealth's public pensions is now subject to oversight board approval. See PROMESA

§ 204(a).

[6] See Bayron Toro v. Serra, No. RE-85-568, 1987 WL 448265, 19 P.R. Offic. Trans. 646, 660 (P.R. Nov. 18, 1987) ("When the employee retires, once he has met all retirement conditions, his pension is not subject to changes or reductions. However, prior to the employee's retirement, the government may amend the terms and conditions of the retirement, if such amendments are reasonable and further seek the actuarial solvency of the system.") (internal citations omitted).

[7] A Title VI proceeding under PROMESA could not be used to adjust pension obligations, because such pension obligations are not "bond claims." In addition, while a consensual amendment with pensioners is technically an option, it may be logistically impractical given practical collective action obstacles and the unlikelihood that pensioners would agree to voluntary cuts.

[8] See Richard J. Cooper, Luke A. Barefoot, Jessica E. McBride and Antonio J. Pietrantoni, "Why Puerto Rico Will Likely Rely On PROMESA Title III," Law360 (Mar. 1, 2017).

[9] One notable exception to the general trend of high pension recoveries is Central Falls, Rhode Island's bankruptcy, in which the majority of pensioners recovered no more than 45 percent of their claims, while bondholders were paid 100 percent. However, Central Falls is generally understood to be an outlier for a variety of reasons, see David A. Skeel Jr., "What is a Lien? Lessons from Municipal Bankruptcy" at 676, 687-88, Penn Law Faculty Scholarship Paper 1387 (2015), including that its retiree class included less than sixty (60) people.

[10] Given existing case law from the PRSC, pensioners may also argue that the requirement that any approved fiscal plan "respect the relative lawful priorities ... in the constitution, other laws, or agreements ... in effect prior to the date of enactment of this Act" requires better treatment for pensioners relative to other constituencies. See PROMESA § 201(b)(1)(N).

[11] See Servidores Públicos Unidos de P.R. v. Fin. Oversight and Mgmt. Bd., No. 17-1483 (D.P.R. 2017), where plaintiffs have sought a temporary restraining order and preliminary injunction against, inter alia, implementation of the certified fiscal plan. In support of their motion, plaintiffs lodged contracts clause, takings and due process claims under both the U.S. and Puerto Rico Constitutions, and also called attention to alleged procedural illegalities in connection with the certification of the fiscal plan. As of the time of publication of this article, such requests for injunctive relief have been denied. Neither the moving papers nor the court's orders to date address the jurisdictional issue presented by § 106(e) of PROMESA.

[12] As with ERS, PREPA's pensions could also be modified consensually (which would require cooperation of the union appointees to the PREPA retirement system board) or legislatively (which would subject any modifications to the same legal challenges discussed elsewhere herein with respect to pension reform and which would require approval of the Legislature that has historically resisted such changes).

[13] See Cooper, Barefoot, McBride & Pietrantoni, supra note 8.

[14] Lack of third-party creditors means that TRS and JRS would also likely be resolved as part of a commonwealth-wide plan.

[15] Though the official statements for the ERS bonds provide that "[t]he Bonds are limited, non-

recourse obligations of the System, payable solely from and secured solely by a pledge of Employer Contributions ...” we do not here take a view on the existence or validity of a lien as a matter of Puerto Rico law.

[16] Indeed, to the extent that ERS bondholders have neither a statutory lien nor collateral that is special revenues, the current arrangements in place between ERS and certain of its bondholders, pursuant to which ERS has agreed to use segregated employer contributions to make ERS bond interest payments, may change if ERS files a Title III proceeding.

[17] The original stay termination deadline was Feb. 15, 2017, and was extended 75 days (until May 1, 2017) on Jan. 28, 2017. As PROMESA does not provide further options for extensions of the Title IV stay, absent legislative change, an extension beyond May 1, 2017, is unlikely. See PROMESA § 405(d).

[18] Applicable collective bargaining agreements may also provide individual retirees with independent rights to pursue claims for benefits.

[19] Though in some circumstances the Bankruptcy Code’s automatic stay may be extended to nondebtors (e.g., to directors and officers so as to minimize distractions or to avoid collateral estoppel for co-liable third parties), in this context it is unlikely that the same arguments would exist for extending the stay to employers not in Title III proceedings.

[20] A split of authority exists as to whether and under what circumstances nondebtor releases are permissible as part of a Chapter 11 plan of reorganization. Compare, e.g., In re Vitro SAB de CV, 701 F.3d 1031, 1061(5th Cir. 2012) (noting that “prior rulings from [the Fifth Circuit] ... seem broadly to foreclose non-consensual non-debtor releases and permanent injunctions”) (internal citations and quotations omitted), with, e.g., In re Metromedia Fiber Network Inc., 416 F.3d 136, 141 (2d Cir. 2005) (noting that “[w]e have previously held that in bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor’s reorganization plan”) (internal citations and quotations omitted). We are not aware of any cases in the First Circuit to address the issue, nor have those courts that restrict third-party releases ruled on the issue in the unique context of Chapter 9. See, e.g., Deocampo v. Potts, 836 F.3d 1134, 1143-44 (9th Cir. 2016) (declining to reach the unsettled issue of third-party releases in a Chapter 9 plan of adjustment); In re City of Detroit, 524 B.R. 147, 265 (Bankr. E.D. Mich. 2014) (approving releases of the state of Michigan and related nondebtor entities as necessary to implementation of the plan of adjustment).