PUBLIC PENSION REFORM: CAN KENTUCKY BE CONSIDERED A MODEL?

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ABSTRACT

Public pensions can be poorly funded, and Kentucky's are among the worst funded in the nation. There are many reasons for this, but the overriding cause is the lack of funding discipline. Pension benefits are legally protected and highly valued, while pension funding is subject to competing social and budgetary goals and constraints. Kentucky has taken steps to shore up its pensions, including reforms of benefits and funding. But pension reform is intensely political, the job is not done, and it remains to be seen whether Kentucky pensions can withstand a prolonged recession. Reformers would therefore be well advised to follow developments in Kentucky.

I. INTRODUCTION

A. The Situation in Kentucky

Kentucky has among the worst-funded public pension plans in the nation.[1] There are several reasons for this, none of them unique to Kentucky, including elected officials' historical failure to seek or to appropriate annual funding, investment losses in the last recession compounded by poor investment decisions, and costly benefit increases.[2] Of these, the first is

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1 *The State Pension Funding Gap: 2017*, PEW CHARITABLE TRUSTS 2 (2019), https://www.pewtrusts.org/-/media/assets/2019/06/statepensionfundinggap.pdf [https://perma.cc/9QH9-NRTZ]. *See also* CHRIS TOBE WITH KEN TOBE, KENTUCKY FRIED PENSIONS 102–05 (2018).

2 Tom Loftus, *Kentucky is in a $43 Billion Pension Hole. Here are Some Reasons Why*, COURIER JOURNAL

probably most important. Regular funding can help sustain a pension system through bad times. As pension advocate Chris Tobe puts it, "if you paid half your mortgage for 12 years straight, you should not be surprised your house is underwater."[3]

The Kentucky Retirement Systems ("KRS") comprises the Kentucky Employees Retirement System ("KERS") (for state and local civil service ("non-hazardous") employees and local uniformed service ("hazardous") employees), the County Employees Retirement System ("CERS"), the State Police Retirement System ("SPRS"), and plans for judges and legislators.[4] KRS units' funding levels differ, from a high of fifty-five percent for the hazardous sector of KERS to a low of thirteen percent for the non-hazardous sector of KERS.[5] Their employer contribution rates vary, from a low of thirty-two percent of payroll for the Tier 1 non-hazardous segment of CERS to a high of one hundred fifty-seven percent of payroll for Tier 1 of SPRS.[6] The Kentucky Teachers' Retirement System ("KTRS"), the largest state system, is separate from KERS, and has a funding level of fifty-eight percent.[7]

Kentucky embarked on a reform plan with the enactment of Senate Bill 2 in 2013.[8] That plan included legal requirements to make the Actuarial Determined Contribution ("ADC") and to prefund cost of living adjustments ("COLAs"), designated several tax revenue sources, and instituted a cash-balance plan with gain sharing instead of a traditional defined benefit plan for new hires.[9] But the reform plan faced significant opposition.[10] A major reason is that it provided no coverage for KTRS.[11] Further reform efforts remain controversial.[12]

(Dec. 17, 2018), https://www.courier-journal.com/story/news/politics/2018/12/17/kentucky-pension-crisis-reasons-how-we-got-here/2317233002/ [https://perma.cc/K49R-A72X]; *See generally* TOBE, *supra* note 1, at 32–33, 39.

[3] TOBE, *supra* note 1, at 410.

[4] KRS, SUMMARY ANN. FIN. REP. 6 (2019), https://kyret.ky.gov/Publications/Books/2019%20SAR%20(Summary%20Annual%20Report).pdf [https://perma.cc/74RH-PPJ5].

[5] *Id.*

[6] *Id.* at 18, 16 (all figures are for non-insured portions of the systems).

[7] KTRS represents a larger exposure than KERS, but that is not well understood. *See* TOBE, *supra* note 1, at 102, 105.

[8] S.B. 2, 13 Reg. Sess. (Ky. 2013).

[9] Maria O'Brien, *The Case for Public Pension Reform: Early Evidence From Kentucky*, 47 CREIGHTON L. REV. 585, 591–93 (2014).

[10] *Kentucky House Passes Two Pension Bills But Controversy Over Vote Looms*, W. KY. UNIV., https://www.wkyufm.org/post/kentucky-house-passes-two-pension-bills-controversy-over-vote-looms#stream/0 [https://perma.cc/9V7A-9XYR].

[11] O'Brien, *supra* note 9, at 96. *See also* TOBE, *supra* note 1, at 400 (noting that teachers are unionized, while many KERS members are not, which may explain why TRS was excluded from the reforms).

[12] Karen Pinchin, *As New Governor Takes Office, Kentucky Pensions Still on the Brink*, PBS (Dec. 10, 2019), https://www.pbs.org/wgbh/frontline/article/kentucky-pensions-beshear-bevin/ [https://perma.cc/3N7E-6GCD].

Contribution increases must be borne by taxpayers. Newer hires have stingier pensions than veteran employees and retirees, which will likely increase wealth and income disparities and slow economic growth. Annual budget wars threaten to destabilize the KTRS, as they once did for KERS.[13] Planned changes in benefit calculations can lead long-service employees to rush for the door.[14] The pension overhang has already affected Kentucky's credit rating and may affect its ability to attract or retain businesses and jobs.[15] It is unclear what impact the next major recession will have on the system.

Had the reforms not come so late, Kentucky could have been considered a model for other states and their political subdivisions. Mandatory funding for its traditional defined benefit plans and for COLAs puts Kentucky in the vanguard. Kentucky's hybrid plan design for new hires is likely to be more sustainable than a traditional defined benefit plan. True, a hybrid plan may provide less income in retirement, but most Americans have no pension and lack significant personal savings.[16]

The challenges Kentucky confronts are worse than in most states, but they are hardly unique. We begin with the historical context.

B. *History of Public Pensions*

1. History of Pension Regulation

Pensions were originally a workforce management tool,[17] as a trained workforce is a valuable asset.[18] But pay increases as workers advance, and workers wear out as they age, at least in industrial jobs.[19] So, at some point it makes business sense to replace older workers. By giving older workers an

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[13] John Cheves, *Taking $1.13 Billion From Teacher Pensions a "Very Serious Problem," Official Warns*, LEXINGTON HERALD-LEADER (Mar. 23, 2020), https://www.kentucky.com/news/politics-government/article241433321.html [https://perma.cc/6QTW-KUWG].

[14] Darcy Costello, *A Drop in Monthly Pension Checks Starting Jan. 1 Could Mean a Wave of Retirements*, COURIER JOURNAL (Sept. 19, 2019), https://www.courier-journal.com/story/news/politics/metro-government/2019/09/19/kentucky-pension-change-could-mean-lower-checks-bump-retirements/2151369001/ [https://perma.cc/HX22-VS8H]; Pinchin, *supra* note 12.

[15] TOBE, *supra* note 1, at 431, 433–34.

[16] BIPARTISAN POL'Y CTR., SECURING OUR FINANCIAL FUTURE: REPORT OF THE COMMISSION ON RETIREMENT SECURITY AND PERSONAL SAVINGS 23 (2016), https://bipartisanpolicy.org/report/retirement-security [https://perma.cc/VW5E-L6RP].

[17] Israel Goldowitz, *Funding of Public Sector Pension Plans: What Can Be Learned From The Private Sector?*, 23 CONN. INS. L.J. 143, 151 (2016).

[18] *Id.*

[19] *Id.*

incentive to retire and new hires an incentive to stay, pensions help to manage turnover.[20]

The first pensions were for the military.[21] Private pensions were first introduced by steel companies, railroads, and public utilities in the late Nineteenth Century.[22] Pensions for federal civilian employees and state and local employees are mainly a Twentieth Century development.[23]

State courts initially saw a pension as a gratuity, and unenforceable.[24] A few courts saw a pension promise as an offer of a unilateral contract—promise for performance—to a class of persons.[25] For example, if an employer promises anyone who works twenty years and reaches age sixty-five a pension of one-third of her final pay for life, any member of the class who meets these conditions would have a contractual right to a pension.[26]

A worker rights theory emerged mainly in other forums.[27] For example, the IRS developed a theory of vesting in plan assets when a plan terminates (or when a major downsizing can be considered a termination for affected employees).[28] The IRS administers the rules that allow pension plans to be tax qualified.[29] No employer wants its plan to be disqualified, given the substantial tax benefits at stake.[30]

The Labor-Management Relations Act, 1947 ("LMRA"), which altered the balance of power between management and labor, included pension provisions.[31] Some unions had negotiated pension plans funded by employers.[32] Congress required that the money be held in trust, that contributions be governed by a written agreement, and that the trust be administered by equal numbers of employer and union appointees.[33] In the wake of the LMRA, some courts held that if the trustees changed eligibility rules and did so arbitrarily, they could be compelled to honor the prior rules.[34]

In 1948, the National Labor Relations Board held that pensions are among the terms and conditions of employment and, as such, a mandatory

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20 *Id.*
21 *Id.*
22 *Id.*
23 *Id.*
24 *Id.*
25 *Id.*
26 *Id.* at 151–52.
27 *Id.* at 152.
28 *Id.*
29 *Id.*
30 *Id.* Employer contributions are deductible, earnings on the fund are not taxed, and employees are taxed only on distribution. 29 U.S.C. §§ 401(a), 402(a), 501(a).
31 Goldowitz, *supra* note 17, at 152.
32 *Id.*
33 *Id.*
34 *Id.*

subject of collective bargaining.[35] In 1958, Congress enacted the Welfare and Pension Plans Disclosure Act,[36] which required all employee benefit plans to file an annual report with the Department of Labor.[37] But there was no comprehensive federal law until the Employee Retirement Income Security Act of 1974 ("ERISA").[38]

2. ERISA Codifies the Worker Rights Theory

ERISA represents the culmination of decades' worth of legal developments that treated pensions as deferred compensation.[39] Among other things, ERISA:

- requires that benefits vest within a reasonable period, so employees do not forfeit their rights if they go to work elsewhere, become disabled, or retire early;
- provides that accrued benefits generally cannot be reduced;
- requires that defined benefit plans be advance-funded;
- imposes duties of loyalty and prudence on fiduciaries;
- opens the federal courthouse door for enforcement actions; and
- provides for federal insurance of defined benefit pension plans if they terminate (single-employer plans) or become insolvent (multi-employer plans).[40]

ERISA represents a compromise. Thus, for instance, ERISA does not require immediate vesting.[41] Instead, a plan may require five years' service.[42] Nor does ERISA require that benefits be fully funded.[43] Rather, it allows a funding shortfall to be amortized over a period of years.[44]

3. ERISA Exempts Public-Sector Plans

Congress exempted state and local plans from ERISA's vesting, funding, and insurance regimes.[45] Congress had several reasons:

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35 *Id.* at 153.
36 *Id.*
37 *Id.*
38 *Id.*
39 *Id.*
40 *Id.*
41 *Id.*
42 *Id.*
43 *Id.*
44 *Id.*
45 *Id.*

- public plans' vesting provisions at that time were more generous than those of private plans;
- "the ability of the governmental entities to fulfill their obligations to employees through their taxing powers was an adequate substitute for both minimum funding standards and plan termination insurance"; and
- "imposition of the minimum funding and other standards would entail unacceptable cost implications to governmental entities."[46]

The legislative history also indicates that Congress did not want to intrude on areas of state concerns.[47] For example, the House Committee on Education and Labor Report stated:

> There are literally thousands of public employee retirement systems operated by towns, counties, authorities, and cities in addition to the state and Federal plans. Eligibility, vesting, and funding provisions are at least as diverse as those in the private sector with the added uniqueness added by the legislative process. For this reason, the Committee is convinced that additional data and study is necessary before any attempt is made to address the issues of vesting and funding with respect to public plans.[48]

On the other hand, some were concerned that public pensions were so generous that it was unlikely that adequate taxes would be allocated to them.[49] Congressman John Erlenborn of Illinois, for example, noted that lawsuits in Philadelphia, Detroit, and Illinois sought to compel funding in amounts ranging from $18 million to $1.7 billion.[50]

Congress commissioned a study to determine "the necessity for federal legislation and standards with respect to such plans."[51] In 1978, the House Committee on Education and Labor issued a Pension Task Force Report on Public Employee Retirement Systems.[52] The Report found that plan

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[46] Rose v. Long Island R. Pension Plan, 828 F.2d 910, 914 (2d Cir. 1987) (internal quotations and citations omitted).

[47] Goldowitz, *supra* note 17, at 159.

[48] *Rose*, 828 F.2d at 914. Three years earlier, the Supreme Court emphasized that "[o]ur Federalism" is a "system in which there is sensitivity to the legitimate interests of both State and National governments." Younger v. Harris, 401 U.S. 37, 44 (1971). And in *National League of Cities v. Usery*, 426 U.S. 833 (1976), the Court held that the Tenth Amendment prevents the federal government from imposing minimum wages on local government employees. *League of Cities* was overruled by *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), based on the reach of the Commerce Clause.

[49] Goldowitz, *supra* note 17, at 159.

[50] *Id.* at 159.

[51] 29 U.S.C. § 1231(a)(3).

[52] Goldowitz, *supra* note 17, at 159.

members, government officials, and the general public were kept in the dark about the true costs of public pensions, and that there was compelling need for uniform actuarial measures to assess their funding requirements.[53] The Report also found serious deficiencies in reporting and disclosure and a need for fiduciary standards.[54]

Bills were regularly introduced after ERISA was passed to establish minimum reporting, disclosure, and fiduciary standards for public plans.[55] Initially dubbed "PERISA," later versions were called "PEPPRA"—the Public Employee Pension Plan Reporting and Accountability Act—to reflect their more limited scope.[56] No such bill was ever enacted.[57]

C. *Structure of Public-Sector Plans*

Public-sector plans fall into one of three categories: single-employer, cost-sharing multiple-employer, and agency multiple-employer.[58] As the name implies, a single-employer plan covers employees of one governmental unit, such as a city or county.[59] A multiple-employer plan covers employees of multiple units.[60] In an "agent" plan, there is a common administration and pooling of assets for investment purposes.[61] But separate accounts are kept, and each employer's share of the asset pool is available to pay benefits only to its own employees, akin to a private-sector "aggregate" of single-employer plans.[62] In a cost-sharing multiple-employer plan, assets are also pooled for benefit payment purposes.[63] Thus, there are inherent cross-subsidies, as in a private-sector multiple-employer or multiemployer plan.[64] The California Public Employee Retirement System (CalPERS), the largest public-sector plan, has both agent and cost-sharing features.[65]

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[53] *Id.* at 159–60.

[54] *Id.*

[55] *Id.* at 160.

[56] *Id.*

[57] *Id.*

[58] Natalya Shnitser, *Funding Discipline for U.S. Public Pension Plans: An Empirical Analysis of Institutional Design*, 100 IOWA L. REV. 663, 688 (2015).

[59] Fact Sheet on the GASB's New Pension Standards: Governments in Single-Employer Defined Benefit Pension Plans, GOV'T ACCT. STANDARDS BOARD 1 (2013), https://www.gasb.org/cs/ContentServer?c=Document_C&cid=1176160451967&d=&pagename=GASB%2FDocument_C%2FDocumentPage [https://perma.cc/6TY2-W2HH].

[60] *Id.*

[61] Shnitser, *supra* note 58, at 688.

[62] *Id.*

[63] *Id.*

[64] *See generally id.*

[65] *Id.*

D. Scale of Public-Sector Plans

U.S. state and local pension systems hold $3.8 trillion in assets.[66] Annual contributions are about $180 billion, including about $130 billion from governmental units.[67] The pension systems had earnings of about $170 billion and paid about $266 billion in benefits.[68] They cover more than twenty million members, including nearly ten million receiving benefits. Benefits average about $26,000 per year.[69] While the overall dependency ratio is about 1:1, the ratio is worse than that in many large states, including California, Illinois, and New York.[70]

Most state and local government employees are covered by a defined benefit pension plan, most with a high-three or another final-pay formula, such as an annuity of 1.5 percent of average pay for the three years for which it was the highest ("high-three") per year of service.[71] In wealthy states like New York, New Jersey, Illinois, Ohio, and California, the average benefit is between $26,000 and $36,000 per year; in poorer states, it is between $14,000 and $26,000.[72] State and local pensions provide up to sixty percent income replacement.[73]

Three-quarters of public employees are covered by Social Security.[74] Social Security has covered public employees voluntarily since 1950.[75] Social Security coverage has been mandatory for those not covered by an employer-provided plan since 1990.[76] The seven million public employees

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66 *State Public Pension Funds' Investment Practices and Performance: 2016 Data Update*, PEW CHARITABLE TRUSTS, 1 (2018), https://www.pewtrusts.org/-/media/assets/2018/09/statepublicpensionfunds investmentpracticesandperformance-2016dataupdate_chartbook.pdf [https://perma.cc/7GKP-85KC].

67 PHILLIP VIDAL, U.S. CENSUS BUREAU, ANNUAL SURVEY OF PUBLIC PENSIONS: STATE AND LOCALLY ADMINISTERED DEFINED BENEFIT DATA SUMMARY BRIEF: 2015 1 (2016), https://www.census.gov/content/dam/Census/library/publications/2016/econ/g15-aspp-sl.pdf [https://perma.cc/2HPS-YWLQ].

68 *Id.*

69 *Id.*

70 *Id. See also* Malcolm Gladwell, *The Risk Pool*, THE NEW YORKER (Aug. 28, 2006), https://www.newyorker.com/magazine/2006/08/28/the-risk-pool [https://perma.cc/RJ6W-W6CM] (defining dependency ratio as ratio of citizens working to those not working, or ratio of active employees to retirees).

71 URB. INST., STATE AND LOCAL GOVERNMENT PENSIONS (2011), https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions [https://perma.cc/HN9D-37ZR].

72 Vidal, *supra* note 67.

73 URB. INST., *supra* note 71.

74 *Issues Regarding the Coverage of Public Employees: Testimony before the Subcomm. on Social Security, Pensions & Family Policy, Comm. on Finance*, U.S. Sen. 3 (2007) (statement of Barbara D. Bovbjerg, Dir. Educ., Workforce, & Income Security), https://www.gao.gov/assets/120/118512.pdf [https://perma.cc/84PE-RXNT].

75 Martha A. McSteen, *Fifty Years of Social Security*, 48 SOC. SECURITY BULLETIN 8, 40–41 (1985), https://www.ssa.gov/policy/docs/ssb/v48n8/v48n8p36.pdf [https://perma.cc/UN2P-WXGV].

76 SOC. SECURITY ADMIN., INTRODUCTION TO STATE AND LOCAL COVERAGE, https://www.ssa.gov/section218training/basic_course_4.htm [https://perma.cc/6PF6-SVQL].

not covered by Social Security are mainly in California, Illinois, Ohio, and Texas; they also include Kentucky teachers.[77] Based on reported data and plan-specific actuarial assumptions, public plans were underfunded by more than $1 trillion.[78] They were seventy-three percent funded on average, with plans in Illinois, Connecticut, and Kentucky less than fifty percent funded.[79]

The unfunded liabilities represent an average taxpayer burden of about $3,000 per capita, with Illinois, Connecticut, and Ohio at about $7,000.[80] Alaska leads the nation at $11,000 per capita, and Puerto Rico is close behind at $10,000.[81] For Kentucky, the figure is $24,700.[82]

E. Pension Politics and Finance

In the past decade, pension obligations have been a major factor in municipal restructurings.[83] Central Falls, Rhode Island, for example, negotiated a benefit reduction that in some cases exceeded forty percent.[84] In its bankruptcy, Detroit negotiated a four-and-a-half percent "headline" benefit reduction, along with other benefit concessions, to resolve litigation with bondholders and present a confirmable plan of adjustment.[85]

Outside bankruptcy, some courts have been more protective.[86] For example, the Illinois Supreme Court held that Chicago cannot reduce pensions despite enacting reforms to put them on sounder financial footing for a greater "net benefit."[87]

Pension funding issues, of course, exist in a larger context of budget politics.[88] To avoid statutory borrowing limits, Detroit set up remote entities to finance pension debt, collateralized the debt with casino tax revenues, and tacked on default insurance and interest-rate swaps.[89] The Chicago "net

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[77] Laura D. Quinby, Jean-Pierre Aubry, & Alicia H. Munnell, *Pensions for State and Local Government Workers Not Covered by Social Security: Do Benefits Meet Federal Standards?*, 80 SOC. SECURITY BULLETIN 3 (2020), https://www.ssa.gov/policy/docs/ssb/v80n3/v80n3p1.html [https://perma.cc/Y4XS-EA6Q].

[78] *The State Pension Funding Gap: 2018*, PEW CHARITABLE TRUSTS 1 (2020), https://www.pewtrusts.org/-/media/assets/2020/06/statepensionfundinggap2018.pdf [https://perma.cc/X5GY-KMJ4].

[79] EQUABLE, STATE OF PENSIONS 2020: NATIONAL PENSION FUNDING TRENDS (Aug. 25, 2020), https://equable.org/state-of-pensions-2020-national-pension-funding-trends/ [https://perma.cc/SX76-MKUE].

[80] Goldowitz, *supra* note 17, at 145.

[81] *Id.*

[82] DATA-Z, KENTUCKY (2020), https://www.data-z.org/state_data_and_comparisons/detail/kentucky [https://perma.cc/QZ7V-PMHP].

[83] Goldowitz, *supra* note 17, at 146.

[84] *Id.*

[85] *Id.*

[86] *Id.* at 147.

[87] *Id.*

[88] *Id.*

[89] *Id.*

benefit" proposal was designed to avoid a property tax increase.[90] New Jersey's former governor declined to follow a law that required inclusion of an actuarially determined "minimum required contribution" as a line item in annual appropriation acts and that conferred a contract right on plan members to that contribution.[91] The State Supreme Court agreed: "The Debt Limitation Clause of the State Constitution interdicts the creation . . . of a legally binding enforceable contract compelling multi-year financial payments in the sizable amounts" at issue.[92]

Cities have sold or pledged assets to fund pension costs. Detroit's "grand bargain" included a purchase of the Detroit Institute of Art's collection by national and local charitable foundations.[93] Chicago and other cities have pledged future parking meter revenues.[94] Scranton, Pennsylvania, monetized its sewer system in part to pay down its pension shortfall.[95] Governor Beshear has proposed to dedicate new cigarette and gambling revenues to Kentucky's pensions.[96]

Pensions, in short, represent a challenge for state and municipal finance.[97] This concern extends to U.S. territories. The Puerto Rico rescue law requires an actuarial study of territorial pensions, though not a compromise of pensions as part of a restructuring plan.[98] Even the pension plan for Marianas Island employees briefly found shelter in bankruptcy until the case was dismissed on jurisdictional grounds.[99]

To be sure, many public plans are reasonably well funded, at least under stated assumptions.[100] In some cases, they survived a larger financial crisis. In 1976, New York State imposed a Financial Control Board with a majority of members appointed by the Governor as a condition of rescuing New York City's finances.[101] The Board remains in place, and retains certain oversight duties.[102] New York City's pensions have respectable funding ratios, though hardly strong ones.[103] As part of the federal rescue of the District of

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[90] *Id.*
[91] *Id.* at 147–48.
[92] *Id.* at 148.
[93] *Id.*
[94] *Id.*
[95] *Id.*
[96] Jacqueline Pitts, *Legislators Question Beshear Administration About Specifics of Budget Proposal*, BOTTOM LINE (Feb. 4, 2020), https://kychamberbottomline.com/2020/02/04/legislators-question-beshear-administration-about-specifics-of-the-budget-proposal/ [https://perma.cc/S6HR-C3CZ].
[97] Goldowitz, *supra* note 17, at 148.
[98] *Id.*
[99] *Id.* at 149.
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] *Id.* at 150.

Columbia's finances in 1997, Congress had the federal government take over $4.8 billion in unfunded pension liability for D.C. police, firefighters, teachers, and judges, froze the plans, adopted an amortization schedule, and authorized replacement plans.[104] The new plans were required to be funded under standards borrowed from ERISA as then in effect, and they have strong funding ratios.[105]

Given the unique legal status of Puerto Rico and its insolvency regime, any pension reforms there would have little if any effect in other jurisdictions. But like Detroit, Puerto Rico may be a bellwether for law reform.

II. LEGAL PROTECTIONS, GOVERNANCE, PLAN DESIGN, AND FUNDING

A. *Benefits Protection for Public-Sector Plans*

1. Constitutional and Statutory Provisions

Federal substantive due process claims are difficult to win. Generally, the government can adjust economic rights so long as it has a rational relationship to a legitimate state interest, such as fiscal health.[106] The federal Takings Clause does not require government compensation except for invasion of "distinct investment-backed expectations."[107] Such claims are generally unsuccessful.[108]

Contract rights are protected against impairment by the federal Contracts Clause and equivalent state provisions.[109] Results under this rubric are more diverse, as the nature of the contract right varies from state to state.[110] Some state laws provide that a contract is formed on the date of hire, such that the pension promise can never be altered except for future hires.[111] In other states, the contract is considered to be formed only upon retirement, such that active workers' benefits can be changed at least for future service.[112]

In some cases, neither the state constitution nor a statute explicitly confers contractual rights.[113] Courts in those states sometimes conclude that

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104 *Id.*

105 *Id.*

106 E. Enters. v. Apfel, 524 U.S. 498 (1998).

107 Penn Cent. Transp. Co. v. New York City, 438 U.S. 104, 127 (1978).

108 AMY MONAHAN, AM. ENTERPRISE INST., UNDERSTANDING THE LEGAL LIMITS ON PUBLIC PENSION REFORM 2 (2013), https://www.nasra.org/Files/Topical%20Reports/Legal/Monahan1305.pdf [https://perma.cc/CD9T-QRFV].

109 *Id.*

110 *Id.*

111 *Id.*

112 *Id.*

113 *Id.* at 3.

a unilateral contract is formed when an employee performs service, under a traditional contract theory.[114] Some courts go further, holding that even future accruals are protected by contract.[115] Even where a contract right exists, a state may override it if necessary to address a general social or economic problem.[116] In such a case, the state must prove that no less drastic modification could have been effective.[117] While structural changes or changes to accrual rates are often overruled, COLAs are generally easier to reduce or eliminate.[118] A contract analysis may protect the basic benefit, but not necessarily a COLA.[119] Yet a COLA is vital to maintaining a retiree's spending power.[120]

In Kentucky, a public pension is protected by the Bill of Rights.[121] Indeed, a pension is considered an "inviolable contract."[122] This imposes limits on legislative reform and provides the backdrop for the litigation discussed below.

2. Governance Proposals

Among measures identified by reformers are more explicit fiduciary duties, a requirement to use reasonable actuarial assumptions, constraints on social investing, more robust disclosure, and stronger funding enforcement mechanisms.[123] Traditional legal enforcement mechanisms are arguably ineffective and haphazard. Lawsuits may founder for lack of standing, for instance. Even the prospect of drastic reforms in a municipal bankruptcy may not suffice.

Commentators have suggested more systematic levers: automatic benefit reductions (if permitted under state law) or automatic tax increases where funding falls below a certain level.[124] Those would tend to align plan members and taxpayers with responsible funding.[125] A requirement of low-risk investing could have a similar effect, as lower assumed returns would

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114 *Id.*
115 *Id.*
116 *Id.*
117 *Id.*
118 *Id.* at 5.
119 *Id.*
120 *Id.*
121 KY CONST. § 19(1).
122 Jones v. Bd. Of Trs., 910 S.W.2d 710, 713 (Ky. 1995). *See also* KRS § 161.714 (regarding the Teachers' Retirement System).
123 Thomas Fitzpatrick and Amy Monahan, *Who's Afraid of Good Governance: State Fiscal Crises, Public Pension Underfunding, and the Resistance to Governance Reform*, 66 FLA. L. REV. 1317, 1319 (2014).
124 *Id.*
125 *Id.* at 1364.

require better funding, all else being equal.[126] New models of pension obligation bonds, in which lenders share in gains and losses or in which coupon rates increase when funding levels drop, could bring about greater market discipline.[127]

An empirical analysis suggests that funding discipline correlates with a requirement of actuarial determination of annual funding, and with the transparency of a single-employer or agent plan.[128]

Greater public disclosure about the costs of funding pensions and the consequences of not funding them could have considerable effect.[129] This could be true whether citizens act out of self-interest or as part of a deliberative democracy.[130]

3. Funding Measures[131]

Under the Government Accounting Standards Board's Statements sixty-seven and sixty-eight, a plan can discount liabilities using an assumed earnings rate, but only to the extent that plan assets can be expected to grow to meet the obligations.[132] Once that "crossover point" is reached, a more conservative bond-like rate must be used.[133]

Most financial economists say that a liability should be discounted based on its own risk characteristics, not those of a mismatched asset.[134] Because pension benefits are due with certainty, they say, the appropriate discount rate is a risk-free rate, such as the yield on U.S. Treasury bonds of similar maturity.[135]

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[126] *Id.* at 1369.

[127] *Id.* at 1370.

[128] Shnitser, *supra* note 58, at 714.

[129] This might include greater media access and greater scrutiny by state attorneys general and oversight bodies. *See* TOBE, *supra* note 1, at 373–77, 380.

[130] Elaine Santos, *What is Deliberative Democracy?*, CENT. FOR DELIBERATIVE DEMOCRACY AND GLOBAL GOVERNANCE (Feb. 15, 2012), https://deldem.weblogs.anu.edu.au/2012/02/15/what-is-deliberative-democracy/ [https://perma.cc/4SGP-UJUP] ("Deliberative democracy is . . . concerned with improving collective decision-making. It emphasizes the right, opportunity, and capacity of anyone who is subject to a collective decision to participate (or have their representatives participate) in consequential deliberation about that decision.").

[131] *See generally* Jeffery Brown & David Wilcox, *Discounting State and Local Pension Liabilities*, 99 AM. ECON. REV. 538 (2009); KEITH BRAINARD & ALEX BROWN, NAT'L ASS'N OF STATE RETIREMENT ADMIN., THE ANNUAL REQUIRED CONTRIBUTION EXPERIENCE OF STATE RETIREMENT PLANS, FY 01 TO FY 13 (2015), http://publicplansdata.org/wp-content/uploads/2015/04/NASRA_ARC_Spotlight.pdf [https://perma.cc/XCT8-N6RH]; Mary Williams Walsh, *CalPERS Cuts Investment Target, Increasing Strain on Municipalities*, N.Y. TIMES (Dec. 21, 2016), https://www.nytimes.com/2016/12/21/business/dealbook/california-calpers-pension-fund-investment.html [https://perma.cc/2MCA-7PLE].

[132] Brown & Wilcox, *supra* note 131, at 538.

[133] *Id.*

[134] *Id.* at 542.

[135] Julia Kagen, *Present Value of an Annuity*, INVESTOPEDIA (Feb. 23, 2021), https://www.investopedia.com/terms/p/present-value-annuity.asp [https://perma.cc/C28Y-Q8Z9]. Discount rate and present value are inversely

If pension liabilities were discounted at a risk-free rate, pension underfunding would be much higher than if they were discounted using an equity-like rate of return. On the other hand, even incremental reforms can have an impact. In 2017, following a nationwide trend, Kentucky reduced its discount assumption from 6.75 percent to 5.25 percent.[136]

GASB has eliminated the requirement to show an Actuarial Require Contribution, or ARC (an accounting concept that includes normal cost and amortization charges).[137] Some have criticized this, saying that payment of an annual amortization charge is as fundamental as paying down a mortgage.[138] They give the New Jersey experience as a case in point. The State took a funding holiday in the late 1990s, when investment returns were strong.[139] The funding ratio dropped precipitously from 2001 to 2013, while the State paid only around forty percent of the ARC on average.[140]

Actuarial standards of practice prescribe a calculation similar to an ARC.[141] And some states require that the actuary's recommended contributions be paid.[142] Others consistently follow the actuary's recommendation, even if not required by law.[143] Conversely, some find excuses not to follow the actuary's recommendation even if the law requires it.[144] In still other states, contributions are a percentage of payroll or other fixed rate and are unrelated to actuarial calculations.[145]

4. Constitutional and Statutory Requirements

Most state constitutions have a balanced budget requirement, effectively limiting debt financing. Many also have limits on taxation.[146] Some state constitutions have spending limits, and some have spending mandates, but only eight require pension funding. Most states do require pension funding

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related; the higher the rate, the lower the present value. *Id.*

136 KENTUCKY ECONOMIC DEVELOPMENT FINANCE AUTHORITY, FINANCIAL STATEMENTS: YEARS ENDED JUNE 30, 2020 AND 2019 5 (2020), https://ced.ky.gov/kyedc/pdfs/Annual_Reports/2020_KEDFA_Audited_Financial_Statements.pdf?92 [https://perma.cc/FL72-MFC5].

137 BRAINARD & BROWN, *supra* note 131.

138 *Id.* at 2.

139 *Id.* at 8.

140 *Id.* at 56.

141 *Id.* at 8.

142 *Id.* at 7.

143 *Id.*

144 *Id.*

145 *Id.*

146 Glenn D. Marrow, *State Constitutional Limitations on the Taxing Authority of State Legislatures*, 9 NAT'L TAX J. 126, 126 (1956).

by statute.[147] Even when funding is required, however, the budget and appropriation cycle can often lag, and at times the process can deadlock.[148]

In New Jersey, for instance, the state's legislature and governor reached an agreement to pay at least one-seventh of the ARC, starting in 2011, phased into the full ARC in 2017.[149] The charge was reflected as a line item in annual appropriations acts, and the law gave plan members a contract right to that contribution.[150] But the governor declined to follow the law, and the State Supreme Court agreed—"The Debt Limitation Clause of the State Constitution interdicts the creation . . . of a legally binding enforceable contract compelling multi-year financial payments in the sizable amounts" at issue.[151] Later, condemning "accounting gimmickry," the governor vetoed a bill calling for quarterly and supplemental pension contributions.[152]

States may also place caps on annual pension contributions.[153] In certain cases, states may issue pension obligation bonds, or establish a one-time appropriation or a dedicated funding source (such as minerals extraction taxes or lottery proceeds).[154]

III. LEGISLATIVE REFORMS AND LITIGATION CHALLENGES

A. *Examples of Reforms*[155]

During the 2008-2009 recession, public-sector plans lost nearly one-third of their investment by value.[156] That sparked a wave of amendments.[157] Chief among them were increases in employee contributions, in some cases temporary, and in others permanent or indefinite.[158] Some added an employee contribution requirement for the first time.[159] Some also reduced benefits, through methods such as using a longer period to compute average salary, using a lower salary multiplier for each year of service, or reducing or

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147 Amy Monahan, *State Fiscal Constitutions and the Law and Politics of Public Pensions*, 2015 U. ILL. L. REV. 117, 134 (2015).

148 *Id.*

149 Burgos v. State of New Jersey, 118 A.3d 270, 276 (N.J. 2015).

150 *Id.*

151 *Id.* at 274–75.

152 Christopher Baxter, *Christie Vetoes Quarterly N.J. Pension Payments Bill, $300M 'Pre-Payment,'* NJ.COM (Jan. 17, 2019), https://www.nj.com/politics/2015/08/christie_vetoes_quartely_nj_pension_payments_bill.html [https://perma.cc/8ZBS-JDSN].

153 BRAINARD AND BROWN, *supra* note 131, at 10.

154 *Id.* at 2.

155 *See generally* BRAINARD & BROWN, *supra* note 131.

156 KENNETH BRAINARD & ALEX BROWN, NAT'L ASS'N. OF STATE RETIREMENT ADMIN., SIGNIFICANT REFORMS TO STATE RETIREMENT SYSTEMS 1 (2018).

157 *Id.*

158 *Id.* at 2.

159 *Id.*

eliminating a COLA.[160] Some states increased the vesting period for new hires from five to ten years.[161] More increased the retirement age, or eliminated a subsidized early-retirement benefit, at least for new hires.[162] And some established cash balance plans, defined contribution plans, or DB-DC arrangements, at least for new hires.[163] Some plans already have risk-sharing features that adjust to investment performance. In a few, for example, employee contributions fluctuate automatically or can be adjusted. In at least one, benefits are adjustable.

B. Examples of Court Decisions

Chicago attempted to put its pensions on sounder footing by reducing COLAs, requiring increased contributions, and providing administrative and judicial remedies to enforce the contribution requirements, a quid pro quo that would yield a greater "net benefit."[164] The Illinois Supreme Court held that the quid pro quo was illusory:

> [M]embers of the Funds already have a legally enforceable right to receive the benefits they have been promised . . . . By offering a purported "offsetting benefit" of actuarially sound funding and solvency in the Funds, the legislation merely offers participants in those funds what is already guaranteed to them—payment of the pension benefits in place when they joined the fund.[165]

By contrast, the Texas Supreme Court upheld Dallas's efforts to shore up its police and fire pension system by reducing and eventually eliminating the interest that accrued on deferred retirement benefits.[166] The Court held that the state constitution's protection of "benefits" applied to "payments and . . . not . . . the formula by which those payments are calculated."[167]

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160 *Id.* at 3.

161 *Id.* at 4.

162 *Id.*

163 *Id.* at 4–5. Such two-tier systems do not necessarily improve funding of old liabilities and may even divert money from that effort. TOBE, *supra* note 1, at 33–34, 39, 55.

164 Jones v. Mun. Employees' Annuity & Benefit Fund of Chicago, 50 N.E.3d 596, 600–02 (Ill. 2016).

165 *Id.* at 607.

166 Eddington v. Dall. Police & Fire Pension Sys., 589 S.W.3d 799, 800 (Tex. 2019).

167 *Id.* at 804.

IV. TREATMENT OF DISTRESSED PLANS AND SPONSORS

A. Out-of-Court Resolutions

Many public plans are reasonably well funded, at least under stated assumptions. In some cases, they survived a larger financial crisis. New York City famously went broke in 1975.[168] In 1976, New York State imposed a Financial Control Board with a majority of members appointed by the Governor as a condition of rescuing New York City's finances.[169] The Board remains in place and retains certain oversight duties.[170] As part of the compromise, the City teachers' pension fund bought bonds of the Municipal Assistance Corporation, which was formed to provide the City with emergency financing.[171] Today, New York City's pensions have respectable funding ratios, though hardly strong ones.[172] In 2011, Central Falls, Rhode Island, negotiated a benefit reduction that in some cases exceeded forty percent.[173] Rhode Island later enacted legislation to restore up to seventy-five percent of the original amounts.[174]

B. Bankruptcy

1. Overview of Chapter 9

Under the U.S. Constitution, Congress may enact "uniform laws on the subject of Bankruptcies. . . ."[175] The current Bankruptcy Code, enacted in 1978, is the latest in a series of laws that govern bankruptcies throughout the United States, overriding any incompatible state laws.[176] Chapter 9 of the Bankruptcy Code provides for the Adjustment of Debts of a Municipality.[177]

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168 Kim Phillips-Fein, *Lessons From the Great Default Crisis of 1975*, THE NATION (Oct. 16, 2013), https://www.thenation.com/article/archive/lessons-great-default-crisis-1975/ [https://perma.cc/H7LJ-VMWZ].

169 Martin Gottlieb, *New York's Rescue: The Offstage Drama*, N.Y. TIMES (July 2, 1985), https://www.nytimes.com/1985/07/02/nyregion/new-york-s-rescue-the-offstage-drama.html [https://perma.cc/4LMY-GRJJ].

170 *Id.*

171 *Id.*

172 Balanced Budget Act of 1997, Pub. L. No. 105-33, §§11001-11087, 111 Stat. 251, 715-31 (1997).

173 Maria O'Brien, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525, 526 (2013).

174 W. Zachary Malinowski, *Chafee Signs Law Giving Retired Central Falls Police, Firefighters Pension Supplement*, PROVIDENCE J. (Aug. 27, 2014), https://www.providencejournal.com/article/20140827/News/308279896 [https://perma.cc/XT79-4HZF].

175 U.S. CONST. art. I, § 8, cl. 4.

176 Lawrence Ponoroff, *Constitutional Limitations on State-Enacted Bankruptcy Exemption Legislation and the Long Overdue Case for Uniformity*, 88 AM. BANKR. L.J. 353, 357 (2014).

177 *See* Peter Benvenutti et al., *An Overview of Chapter 9 of the Bankruptcy Code; Municipal Debt Adjustments*, JONES DAY (Aug. 2010), https://www.jonesday.com/en/insights/2010/08/an-overview-of-chapter-9-

Section 109(c) of the Code requires that a state or state official authorize a municipality's filing for bankruptcy, which in turn brings into play state laws governing the powers of state officials.[178] Fewer than half of the states permit their officials to grant such authority.[179] Twelve states do so unconditionally; they include Kentucky.[180] Another twelve do so conditionally.[181] For instance, Michigan permits its governor to authorize a bankruptcy filing by a local government in receivership on the recommendation by its Emergency Manager that bankruptcy is necessary to "rectify[] the financial emergency of the local government."[182] The authorization may be with or without "contingencies."[183] The remaining states do not permit officials to authorize a municipal bankruptcy at all, absent special legislation.[184]

In the past decade, only a few cities or other general-purpose governmental units have filed for bankruptcy.[185] Among the causes are a declining tax base (both income and property), increased borrowing costs, generous pensions coupled with lack of funding discipline, and unrealistic accounting assumptions.[186]

For a municipality to qualify for bankruptcy relief, it must show that it is insolvent.[187] This is a cash-flow test—general inability to pay debts as they come due.[188] The municipality must desire to effect a plan to adjust its debts, and the plan of adjustment must satisfy one of the following tests:

- Has obtained consents of impaired creditors by the requisite majority;
- Has failed to obtain such consents after good-faith negotiation;

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of-the-bankruptcy-code-municipal-debt-adjustments [https://perma.cc/T7SU-CXPY].

178 *Id.*

179 *Id.*

180 Kenneth E. Noble & Kevin M. Baum, *Municipal Bankruptcies: An Overview and Recent History of Chapter 9 of the Bankruptcy Code*, KATTEN MUCHIN ROSENMAN LLP (July 23, 2013), https://katten.com/municipal-bankruptcies-an-overview-and-recent-history-of-chapter-9-of-the-bankruptcy-code [https://perma.cc/2UFA-W4PP].

181 *Id.*

182 MICH. COMP. LAWS SERV. § 141.1558 (LexisNexis 2020).

183 *Id.*

184 Benvenuitti et al., *supra* note 177.

185 Mary Murphy & Matthew Cook, *Pew Trusts, Local Governments Rarely File for Bankruptcy*, PEW RES. CTR. (2018), https://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2018/02/local-governments-rarely-file-for-bankruptcy [https://perma.cc/KS5S-NMN3].

186 *See* Susan K. Urahn et al., *Pew Trusts, After Municipal Bankruptcy*, PEW RES. CTR. 6 (2015), https://www.pewtrusts.org/-/media/assets/2015/08/after-municipal-bankruptcy-pdf.pdf [https://perma.cc/FXF9-M7K2].

187 Andrea Saavedra & Christopher Hopkins, *The Statutory Definition of "Insolvent,"* WEIL RESTRUCTURING (Nov. 5, 2013), https://restructuring.weil.com/chapter-9/the-statutory-definition-of-insolvent-part-two-chapter-9-debtors/ [https://perma.cc/3RNY-CCMY].

188 *Id.*

- Negotiation is impracticable; or
- It reasonably believes a creditor is about to obtain a voidable preference.[189]

Finally, the plan must be proposed in good faith, determined through a facts and circumstances test.[190]

A reorganizing debtor may reject executory contacts, thus relieving itself of burdensome obligations going forward.[191] Rejection by the debtor is a breach, resulting in a bankruptcy claim for the other contracting party, but a general unsecured claim that may be paid in cents on the dollar.[192]

Labor contracts enjoy special protection in corporate reorganizations. Under section 1113, they can be modified or rejected only after good-faith bargaining and only to the extent deemed necessary.[193] That provision does not apply under Chapter 9, so the pre-section 1113 caselaw applies.[194] That caselaw imposes a lesser bar—that the municipality must have made reasonable efforts to resolve issues with the union, and that the balance of equities and the relative hardships favor modification or rejection of the contractual provisions.[195]

While pensions were at issue in some earlier cases, such as *In re City of Vallejo* (California) and *In re City of Prichard County* (Alabama), they were not confronted head-on until the past few years.[196] Those cases had, however, suggested that labor agreements could be rejected as executory contracts, notwithstanding state labor laws to the contrary.[197]

Recognizing constitutional limits within the federal system, the Bankruptcy Code prohibits interference with the municipality's political or government power, its property or revenue, or its income sources.[198] For example, the bankruptcy court may not appoint a trustee or permit a secured creditor to sell property in satisfaction of its lien.[199] On the other hand, the

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189 Benvenuitti et al., *supra* note 177.

190 *Id.*

191 *Id.*

192 *Id.*

193 T. Daniel Reynolds & Mark G. Douglas, *First Impressions: Third Circuit Rules That a Terminated Collective Bargaining Agreement May Be Rejected Under Section 1113*, JONES DAY (May/June 2016), https://www.jonesday.com/en/insights/2016/06/first-impressions-third-circuit-rules-that-a-terminated-collective-bargaining-agreement-may-be-rejected-under-section-1113 [https://perma.cc/VEU3-QSMV].

194 *Id.*

195 *Id.*

196 See In re City of Vallejo, 403 B.R. 72 (Bankr. E.D. Cal. 2009). *See also* In re City of Prichard, Civil Action No. 1:10-00622-KD-M, 2011 U.S. Dist. LEXIS 68747 (S.D. Ala. May 17, 2011).

197 In re Vallejo, 403 B.R. at 77.

198 U.S. CTS., CHAPTER 9 – BANKRUPTCY BASICS, https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics [https://perma.cc/QC6V-WK27].

199 *Id.*

Code preserves liens on dedicated revenue streams, such as those secured by project finance loans.[200]

The municipality has no time limit to propose a plan of adjustment, and no one else can propose one.[201] Once a plan is proposed, its confirmation must be preceded by a court-approved disclosure statement.[202] The plan must then be accepted by each impaired class (any class that will not receive full payment under the plan is deemed "impaired") by a vote of one-half of the creditors by number and those holding two-thirds of the claims by amount.[203] A plan must propose to pay all post-petition priority claims, such as costs of administration, in full; it must have all required legislative and electoral approvals; it must be feasible; and its implementation may not be prohibited by law.[204]

A plan may impair unsecured claims, for example, by altering interest rates or maturities, as long as that does not run afoul of state law.[205] It may also "cram down" on dissenting classes if it does not unfairly discriminate against them and is fair and equitable.[206] The latter means the dissenters are getting all they can reasonably expect under the circumstances.[207] A plan may not, however, alter rights under derivative contracts, such as the counter-party's right to terminate, to net offsetting amounts, or to apply collateral to the debt, under statutory safe harbors.[208]

2. Examples

While States cannot seek bankruptcy protection, in Kentucky, political subdivisions may. This is relevant for counties and cities participating in KRS. We therefore present three case studies.

a. *Stockton, California (2015)*

Stockton filed for bankruptcy largely as a result of the Great Recession of 2008.[209] It had a twenty-two percent unemployment rate, property values

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[200] Juliet M. Moringiello, *Municipal Capital Structure and Chapter 9 Creditor Priorities* 10 (2016) (paper presented at the 5th Annual Municipal Finance Conference), https://www.brookings.edu/wp-content/uploads/2016/10/moringiello1.pdf [https://perma.cc/G5T9-6SXB].

[201] Bienvenutti et al., *supra* note 177.

[202] *Id.*

[203] *Id.*

[204] *Id.*

[205] *Id.*

[206] *Id.*

[207] *Id.*

[208] *Id.*

[209] In re City of Stockton, 493 B.R. 772, 778 (Bankr. E.D. Cal. 2013).

had declined by fifty percent, and it had one of the highest foreclosure rates in the nation.[210] Revenues declined accordingly, while the city was locked into what the court called a "creeping, multi-decade, opaque pattern of overcompensation of employees."[211] Among other things, the city provided lifetime health coverage even to short-service retirees, "add-pays" for certain tasks, fixed cost-of-living adjustments, and a final-pay formula for pensions, with pensionable earnings enhanced by unlimited accrued vacation and sick leave.[212]

In the run-up to bankruptcy, Stockton imposed on non-union workers unpaid furloughs, higher health care premiums and copayments, limits on annual and sick leave, a high-three pension formula (instead of a final-year formula), an end to pension credit for accrued vacation and sick pay, a higher retirement age, and a seven percent employee contribution.[213] It negotiated similar concessions with unionized workers.[214]

Reductions in the workforce had imposed great social costs.[215] In particular, with an inadequate police force, violent crime spiked, and police could respond only to crimes in progress.[216] The city was therefore on the verge of a "service delivery insolvency," as well as financial insolvency.[217] Stockton suspended payment on various bond issues, which allowed secured creditors to install receivers and capture dedicated parking and other revenue streams.[218]

Before filing for bankruptcy, the city engaged in a neutral evaluation before a former bankruptcy judge, a process required by California law.[219] It was able to negotiate further concessions with labor, but certain bondholders refused to negotiate unless the city attempted to withdraw from CalPERS.[220]

The court ultimately held that the city was eligible for bankruptcy protection.[221] It was insolvent in every relevant sense—cash flow, balance sheet, and service delivery.[222] It could not raise taxes, because state law requires taxpayer approval, and experience shows that taxpayers vote for tax

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210 *Id.*
211 *Id.* at 779.
212 *Id.*
213 *Id.* at 779–80.
214 *Id.* at 780.
215 *Id.*
216 *Id.* at 780–81.
217 *Id.* at 781.
218 *Id.*
219 *Id.*
220 *Id.* at 782.
221 *Id.* at 787.
222 *Id.* at 787–91.

increases only when a city has "gotten its house in order."[223] Stockton desired to implement a debt adjustment plan.[224] This was evidenced by its proposals during the early evaluation, and by its making unilateral reductions at the outset of the case, in effect "burning its bridges" and committing to the bankruptcy process for exoneration.[225] Finally, it had negotiated in good faith.[226] To be sure, the city had made aggressive proposals, including an interest holiday and deferral of principal repayment, but was willing to add value in other ways.[227] But the financial creditors insisted that this was a one-way obligation and had refused to negotiate unless the city took on CalPERS.[228] While that might be done as part of a plan of adjustment, it could not be a condition of pre-bankruptcy bargaining.[229]

Stockton then sought to withdraw from CalPERS.[230] In an interim opinion, the bankruptcy court held that the city was authorized to reject its contract with CalPERS and to avoid a statutory "termination lien" for pension underfunding under California law, because the Bankruptcy Code preempts incompatible state law.[231]

CalPERS is an "agent multiple-employer plan," with common administration of separate plans for participating employers rather than a single risk pool.[232] As noted above, for funding purposes, CalPERS values liabilities using an equity-like rate.[233] But when an employer withdraws, CalPERS assesses contractual withdrawal liability, using more conservative closeout assumptions.[234] In Stockton's case, that would have resulted in a claim for $1.6 billion, enforceable by a statutory lien.[235]

Stockton later reconsidered and struck a bargain that allowed it to retain its pensions.[236] Among other things, city employees agreed to reductions in pay (which in turn reduced pension accruals) and retirees agreed to elimination of health benefits.[237] Based on those sacrifices, the court confirmed the plan of adjustment.[238] While "pensions may, as matter of law,

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223 *Id.* at 790.
224 *Id.* at 791.
225 *Id.* at 791–92.
226 *Id.* at 792–95.
227 *Id.* at 793.
228 *Id.*
229 *Id.* at 794.
230 In re City of Stockton, 526 B.R. 35, 38–39 (Bankr. E.D. Cal. 2015).
231 *Id.*
232 Shnitser, *supra* note 58, at 689.
233 *Id.* at 680.
234 *Id.*
235 *In re City of Stockton*, 526 B.R. at 38.
236 *Id.* at 39.
237 *Id.*
238 *Id.*

be modified by way of a Chapter 9 plan of adjustment," the Court held, and while a CalPERS contract "may be rejected without fear of an enforceable termination lien," the plan was both feasible and in the best interest of creditors.[239] The court therefore overruled the objections of a dissenting lender.[240]

b. Detroit, Michigan (2015)

Detroit, Michigan had suffered sixty percent declines in jobs and population since its peak in the 1950s.[241] The city had a violent crime rate five times the national average, a police response time of six times the national average, a large number of fires, blighted properties, vacant lots, and forty percent of its streetlights dark.[242]

The city had seen a thirty percent reduction in income tax revenues and a similar reduction in user fee revenues in a decade, and a ten percent reduction in property tax revenues in just three years.[243] While it had substantial gaming tax revenues, that was not likely to grow due to nearby competition. State revenue sharing had declined nearly fifty percent in a decade.[244]

The city faced more than $6 billion in secured debt and about $12 billion in unsecured debt.[245] The unsecured debt was largely for employee benefits: $3.5 billion in underfunded pensions, $5.7 billion in other post-employment benefits ("OPEB"), $1.4 billion for certificates of participation ("COPs") related to pension borrowings, and $300 million for swaps related to the COPs.[246]

The pension plan for police and fire employees provided an average benefit of $30,000, and those retirees were not eligible for Social Security.[247] The general pension plan provided an average benefit of $18,000, but those retirees were eligible for Social Security.[248]

Benefit payments for the two plans had exceeded contribution and investment income by more than $3 billion over the five years ending in 2012.[249] Contributions to the police and fire plan were expected to grow from

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239 *Id.* at 62.
240 *Id.*
241 In re City of Detroit, 504 B.R. 191, 213 (Bankr. E.D. Mich. 2013).
242 *Id.* at 214.
243 *Id.* at 212.
244 *Id.*
245 *Id.* at 207.
246 *Id.* at 207–08.
247 *Id.* at 208.
248 *Id.*
249 *Id.* at 208–09.

thirty percent of payroll to seventy percent by 2017, with contributions to the general plan rising from twenty-five percent to thirty percent.[250] There were more than twenty-two non-pension benefit plans, mainly unfunded.[251] The cost of pension and retiree medical benefits were projected to rise from thirty-eight percent of revenues in 2012 to sixty-four percent by 2017.[252]

The city had used a 7.9 percent or 8.0 percent interest rate assumption to value benefit liabilities, which understated the funding problem.[253] It had also depleted plan assets by paying a "thirteenth check" during flush times and overstating the earnings transferred to commonly managed annuity accounts.[254]

In 2006, to avoid statutory borrowing limits, the city set up remote entities to finance pension debt.[255] The city borrowed $1.4 billion in pension funding though service corporations that issued COPs.[256] The COPs represented a right to the repayments the city would make to the service corporations.[257] The COPs were backed by monoline insurance to support marketability.[258]

Some of the COPs paid a variable interest rate.[259] To hedge against a rise in interest rates, the city bought swaps under which, if rates rose, the counter-parties would pay the difference.[260] But if rates fell, the service corporations and the city would owe more.[261] The swaps themselves were backed by insurance.[262]

In fact, interest rates fell, so the city owed about $50 million per year for ten years on the losing bet.[263] To prevent a default, the city pledged some of its gaming tax revenues.[264] When further defaults occurred, a termination loomed, along with a $300 million termination fee.[265] On the eve of bankruptcy, the city settled that claim at between an eighteen and twenty-five

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250 *Id.*
251 *Id.* at 209.
252 *Id.*
253 *Id.* at 208.
254 Goldowitz, *supra* note 17, at 159.
255 *In re City of Detroit*, 504 B.R. at 209.
256 *Id.*
257 *Id.*
258 *Id.*
259 *Id.*
260 *Id.* at 209–10.
261 *Id.* at 210.
262 *Id.*
263 *Id.*
264 *Id.*
265 *Id.* at 211.

percent discount.[266] But that triggered a claim by the insurers, and a large part of city revenues were thus trapped in a lockbox account.[267]

Thirty-eight percent of city revenue went to debt service, estimated to rise to sixty-five percent within five years.[268] The city had run an operating deficit for seven years.[269] Had it not deferred pension contributions or payment on the COPs, "it would have run out of cash."[270]

Under Michigan law, the state treasurer reported to the governor that the city suffered "probable financial stress," based on its deficit spending, lack of a deficit reduction plan, mounting debt, a junk-bond rating, cash flow shortages, and pension plan borrowing and deferrals.[271] When interim steps failed, leading to a "financial emergency," the Governor appointed an emergency manager, who supplanted local government and had the powers of a receiver.[272]

The City proposed a plan that would:

- Improve services, including reduction of the street-light footprint, blight removal, and labor and work rule reforms;
- Rationalize taxation and improve tax collection;
- Monetize its water department, by creating a metropolitan area water authority;
- Refinance secured debt to the extent of the value of collateral, without impairment; and
- Issue $2 billion in interest-only notes to unsecured creditors including general obligation bonds, the COPs, the pension systems, and retirees on account of OPEB claims.[273]

The city met with interested parties but ultimately did not negotiate.[274] The governor authorized the bankruptcy filing without contingencies—such as preservation of pensions—except that the plan of adjustment be feasible.[275] Many of those parties objected to the bankruptcy filing.[276] Rejecting legal objections, the court held that:

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[266] *Id.*
[267] *Id.* at 210–11.
[268] *Id.* at 212.
[269] *Id.*
[270] *Id.* at 213.
[271] *Id.* at 216–17.
[272] *Id.* at 219.
[273] *Id.* at 220–21.
[274] *Id.* at 221–22.
[275] *Id.* at 222.
[276] *Id.*

- The state's emergency manager law did not violate Congress's authority to enact "uniform laws" on bankruptcy, though outcomes could differ depending on state law;[277]
- Chapter 9 did not violate the "Contracts Clause" of the U.S. Constitution, which applies only to the States, or the Tenth Amendment, which limits federal power over the States;[278]
- Michigan's constitutional protection of pensions as contracts that cannot be impaired or diminished is not absolute to the extent incompatible with the U.S. Bankruptcy Code;[279] and
- A state law that authorizes a city's bankruptcy filing cannot absolutely safeguard pensions, as it cannot override the federal order of priorities.[280]

Turning to factual questions, the court found that:

- The city was insolvent, whether on a balance sheet or cash flow basis, as it had deferred pension payments and was therefore was "generally not paying its debts as they came due," and its service-delivery insolvency rendered it "unable to pay its debts as they become due";[281]
- The city's proposal of a plan of adjustment demonstrated that it desired to effect a plan;[282]
- The city had not negotiated in good faith, but negotiations were impracticable because of the scale of the city's operations and debts and the number of unrepresented parties (the unions disclaimed representation of retirees, and retiree associations lacked representational status unless they brought a class action), and time was running out;[283] and
- The petition was filed in good faith, even though it had been orchestrated by the state and its professionals and may have been a "foregone conclusion."[284] If anything, it should have been filed earlier.[285]

As part of a "grand bargain," Detroit negotiated a benefit reduction of up to four-and-a-half percent, along with other benefits concessions, to resolve litigation with bondholders and present a viable plan of adjustment.[286] The

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277 *Id.* at 244, 255.
278 *Id.* at 244.
279 *Id.* at 244, 247–48.
280 *Id.* at 255.
281 *Id.* at 262–63.
282 *Id.* at 270–73.
283 *Id.* at 270–73.
284 *Id.* at 280.
285 *Id.*
286 Eighth Amended Plan for the Adjustment of Debts of the City of Detroit at 65, In re City of Detroit, 504 B.R. 191 (Bankr. E.D. Mich. 2013) (No. 8045), https://detroitmi.gov/sites/detroitmi.localhost/files/2018-

bargain included a cash contribution by the state to settle claims by national and local charitable foundations as part of the purchase of the Detroit Institute of Art's collection.[287] Other pension provisions of the bargain included:

- Allowed claims of $1.25 billion and $1.879 billion for the two pension systems;
- Discount rate and earnings assumption of 6.75 percent, and funding targets that will eventually reach 100 percent;
- A plan freeze, with hybrid plans for future accruals;
- A sharp reduction or elimination of COLAs; and
- Recoupment of moneys diverted to the annuity savings fund.[288]

Addressing the favored treatment of the pensions as compared to other creditors, the court held that the city is a municipal service enterprise whose "employees and retirees are and were the backbone of the structures by which the city fulfills its mission."[289] The discrimination in favor of the pension claims was therefore necessary to the city's mission.[290] In addition, the state constitution singles out municipal pension claims for special protection.[291] While bankruptcy law preempts the state constitution to the extent that it conflicts with the Bankruptcy Code, the constitutional provision "expresses the considered judgment of the people" of the state and is "entitled to substantial deference."[292] That provision also influences the expectations of parties, including those to the various interrelated settlements that made up the plan of adjustment.[293]

Dissenting pensioners appealed.[294] The Court of Appeals upheld the bargain under the doctrine of equitable mootness—which prevents appellate courts from "unscrambling complex bankruptcy reorganizations."[295]

05/Detroit%20-%20Eighth%20Amended%20Plan%20of%20Adjustment%208045.pdf [https://perma.cc/W9LW-Y2MV].

287 *Id.*

288 *Id.* at 45–48, 528–29, 537–38.

289 In re City of Detroit, 524 B.R. 147, 257 (Bankr. E.D. Mich. 2014).

290 *Id.*

291 *Id.*

292 *Id.*

293 *Id.*

294 Ochadleus v. City of Detroit (In re City of Detroit), 838 F.3d 792 (6th Cir. 2016).

295 *Id.* at 798 (citing In re Ormet Corp., 355 B.R. 37, 40–41 (S.D. Ohio 2006) (relying on In re Grimland, Inc., 243 F.3d 228, 231 (5th Cir. 2001), and In re PWS Holding Corp., 228 F.3d 224, 236 (3d Cir. 2000))).

c. *Puerto Rico*

In June 2016, Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"), 48 U.S.C. §2101 et seq. (2016), establishing an Oversight Board to restructure the island's $72 billion in debt and balance its budget.[296] PROMESA requires an actuarial study of territorial pensions, but not a compromise of pensions as part of a restructuring plan.[297]

PROMESA authorizes the Oversight Board to conduct an actuarial analysis of any underfunded territorial pension plan to aid in evaluating the fiscal and economic impact of the pension cash flows.[298] Such an analysis would include:

- an actuarial study of the pension liabilities and funding strategy that includes a forward-looking projection of payments of at least 30 years of benefit payments and funding strategy to cover such payments;
- sources of funding to cover such payments;
- a review of the existing benefits and their sustainability, and
- a review of the system's legal structure and operational arrangements, and any other studies of the pension system the Oversight Board shall deem necessary.[299]

At about the same time, an audit indicated that Puerto Rico's Employees' Retirement System, with a reported $30 billion in liabilities, would run out of funds within a year.[300]

In March 2017, the Oversight Board approved a restructuring plan, proposed by the governor.[301] The plan was to provide a basis for negotiation with Puerto Rico's creditors, who hold $70 billion of defaulted debt.[302] Among other things, it would convert the public employee defined benefit plans to a pay-as-you-go system, with benefit cuts as yet unspecified.[303] It would put current public employees into a defined contribution plan and require that new hires and younger current employees be enrolled in Social Security.[304]

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296 Goldowitz, *supra* note 17, at 148–49.
297 *Id.* at 149.
298 *Id.* at n.18.
299 *Id.*
300 *Id.*
301 Mary Williams Walsh, *Puerto Rico, Mired in Debt, Has a New Rescue Plan*, N.Y. TIMES (Mar. 13, 2017), https://www.nytimes.com/2017/03/13/business/puerto-rico-debt-crisis-oversight-board.html [https://perma.cc/W6K9-Q49H].
302 *Id.*
303 *Id.*
304 *Id.*

On May 3, 2017, Puerto Rico commenced a bankruptcy-like proceeding under PROMESA, to be overseen by a U.S. District Court judge.[305] Its pensions are underfunded by a reported $49 billion. In the wake of Hurricane Maria, the prospects for pension reform remain uncertain.[306]

V. RECENT DEVELOPMENTS IN KENTUCKY

A. Litigation

1. *Bevin v. Commonwealth ex rel. Beshear*: Pension Reform Averted by the Judiciary and a Divided Executive Branch

In a case involving all three branches of government, *Bevin v. Commonwealth of Kentucky ex rel. Beshear*,[307] the Kentucky Supreme Court held that a bill reducing pensions could not be substituted for a bill on another subject unless that was done in time for readings in each House on three successive legislative days.[308]

Senate Bill 1, "AN ACT relating to retirement" under KRS, CERS, SPRS, and KTRS, would have reduced COLAs, put newly hired teachers into a cash balance plan, and limited the use of sick leave toward pension credit.[309] Protests ensued and the bill was sent back to committee for further study.[310]

Under the Kentucky Constitution, a bill must be read on three successive legislative days in each house.[311] With only three days left in the legislative session, the House substituted a modified pension reform bill for the text of a bill on wastewater treatment that had already had two readings.[312] The bill differed from S.B. 1 in that it applied only to new hires. Both houses passed the bill. Its title was then conformed to its subject matter (pensions), and the governor signed it into law.[313]

Legislators had complained about various rule violations, such as lack of germaneness and the absence of a budget note or local government impact

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305 Walsh, *supra* note 301.

306 Stephen J. Lubben, *Puerto Rico: Act III*, HARVARD LAW SCHOOL BANKRUPTCY ROUNDTABLE (Dec. 2020), https://blogs.harvard.edu/bankruptcyroundtable/tag/stephen-j-lubben [https://perma.cc/D34B-R84S] ("The bondholders want to recover as much as possible, of course, and are leery of settling claims only to see the debtor rebound shortly thereafter. The conundrum being that the rebound is unlikely to happen without serious debt reduction. Debt reduction is often not the only requirement for a rebound, but it is fundamental.").

307 Bevin v. Commonwealth ex rel. Beshear, 563 S.W. 3d 74 (Ky. 2018).

308 *Id.*

309 *Id.* at 78.

310 *Id.* at 78–79.

311 KY. CONST. § 46.

312 *Bevin*, 563 S.W. at 79.

313 *Id.* at 80.

statement.[314] No one objected to the substitution of the bill to evade the three-readings requirement.[315] Apparently, substitution was common practice.[316]

Nevertheless, on suit by the police and teachers' unions, the boards of KRS and KTRS, and the Kentucky Attorney General, the trial court held that the bill violated the three-readings requirement.[317]

The Supreme Court affirmed, first holding that the case was justiciable and did not raise a political question.[318] The Court held that the three-reading requirement was mandatory, not merely directory.[319] The Court also distinguished cases where a bill was amended between readings with this one, where the bill was gutted with virtually no notice.[320] That, the Court said, deprived legislators of a fair opportunity to consider the bill.[321]

2. *KERS v. Seven Counties*: Sixth Circuit Requires KERS Funding During Bankruptcy of Nongovernmental Entity

In *Kentucky Employees Retirement System v. Seven Counties Services, Inc.*, the U.S. Court of Appeals for the Sixth Circuit considered whether a privatized mental health agency participating in KERS can reject or modify its obligations to KERS in a Chapter 11 bankruptcy.[322] Seven Counties had participated in KERS for forty years by executive order of the governor.[323]

Like Stockton and Detroit, Seven Counties found its pension contributions rising to unmanageable levels, from twenty-four percent to thirty-nine percent of compensation in less than a year and a half.[324]

KERS argued that Seven Counties was a governmental unit and, as such, was ineligible to file for Chapter 11 bankruptcy.[325] The Bankruptcy Court held otherwise and the Sixth Circuit affirmed.[326] The Court of Appeals reasoned that the test is whether the state controls the entity, and the Commonwealth did not control Seven Counties because:

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314 *Id.*
315 *Id.*
316 *Id.*
317 *Id.* at 77.
318 *Id.* at 82.
319 *Id.* at 86.
320 *Id.* at 91–92.
321 *Id.* at 93.
322 Ky. Emple. Ret. Sys. v. Seven Counties Servs., Inc., 823 Fed. App'x. 300 (6th Cir. 2020).
323 *Id.* at 301. Such quasi-public entities (or "quasis") account for a significant portion of KERS' assets. Their ADC rose to about eighty-four percent of payroll in 2018–19. TOBE, *supra* note 1, at 447–49.
324 *Ky. Emple. Ret. Sys.*, 823 F. App'x at 302.
325 *Id.* A governmental unit may not file for reorganization under Chapter 11 of the Bankruptcy Code. 11 U.S.C. §§ 101(41), 109(a).
326 *Ky. Emple. Ret. Sys.*, 823 F. App'x at 302–03.

- The Commonwealth did not create Seven Counties;
- The Commonwealth does not appoint Seven Counties' leadership;
- Seven Counties does not operate pursuant to an organic statute;
- Seven Counties may receive public funding and have taxing power, but it has not exercised that power; and
- The Commonwealth cannot end Seven Counties' existence.[327]

The Sixth Circuit referred to the Kentucky Supreme Court the question of whether Seven Counties' relation to KERS was statutory or contractual.[328]

The Supreme Court held that the relationship between Seven Counties and KERS is "based on a statutory obligation."[329] Further, though the relationship between KERS and its members is an "'inviolable contract,' the statute by which employers join KERS contains no such contract language[.]"[330] Moreover, "[p]ayments by an employer to KERS . . . are essentially assessments, statutorily-imposed contributions to the KERS trust fund . . . The relationship between KERS and Seven Counties, is and always has been purely statutory."[331]

On return to the Sixth Circuit, KERS argued that Section 959(b) of the Judicial Code requires that Seven Counties maintain the status quo.[332] Section 959(b) required the debtor to "manage and operate the property according to the requirements of the valid laws of the State in which such property is situated[.]"[333]

Courts generally hold that this provision applies only as necessary to protect public health and safety, such as compliance with environmental protection laws.[334] The Sixth Circuit held, however, that Section 959(b) required Seven Counties to comply with its obligations to KERS for the duration of the bankruptcy.[335]

In the interim, Seven Counties had confirmed a plan of reorganization, under which it continued its participation in KERS and provided for curing the arrearages if it was unable to reject participation in KERS as an executory

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[327] *Id.* at 728–29.
[328] *Id.* at 722.
[329] Ky. Emples. Ret. Sys. v. Seven Ctys. Servs., Inc., 580 S.W.3d 530, 532 (Ky. 2019).
[330] *Id.* at 546.
[331] *Id.*
[332] *Ky. Emples. Ret. Sys.*, Fed. Appx. at 302–03.
[333] 28 U.S.C. § 959(b) (1948).
[334] *E.g.*, In re Wall Tube & Metal Products Co., 831 F.2d 118, 121–22 (6th Cir. 1987) (addressing this issue in terms of hazardous waste cleanup); Robinson v. Michigan Consol. Gas Co. Inc., 918 F.2d 579, 585–86 (6th Cir. 1990) (addressing this issue in regard to termination of utilities).
[335] *Ky. Emples. Ret. Sys.*, Fed. Appx. at 305.

contract.[336] It remains to be seen whether Seven Counties can continue to meet its obligations to KERS. Seven Counties is the largest of the "quasis,"[337] so the case bears watching.

3. *Overstreet v. Mayberry*: Court Adopts Federal Limits on Standing

Just last year, in *Overstreet v. Mayberry*, the Kentucky Supreme Court held that plan members do not have standing to challenge KRS's failed investments.[338] Current and former members sued KRS trustees and officers and various third parties for investing in a hedge fund in an attempt to invest their way out of the funding crisis.[339] They alleged losses of more than $100 million resulting from fiduciary breach, aiding and abetting a breach, and related claims.[340]

KRS declined to join the suit but authorized the plaintiffs to proceed derivatively.[341] Relying heavily on federal precedent, the Supreme Court held that the members lacked constitutional standing to sue.[342] In *Spokeo v. Robins*,[343] the U.S. Supreme Court had held that constitutional standing requires an injury in fact that is both "particularized" and "concrete."[344] And in *Thole v. U.S. Bank*,[345] the Supreme Court applied that logic to a suit by participants in a defined benefit plan for breach of fiduciary duty.[346] The Court explained that in a defined benefit plan, the risk of a funding shortfall is on the employer, so employees do not suffer injury in fact when investments decline in value.[347] For beneficiaries of a private trust or participants in a defined contribution plan, "every penny of gain or loss is at the beneficiaries' risk."[348] By contrast, a defined benefit plan is more in the nature of a contract. The plan participants' benefits are fixed, regardless of how well or how poorly the plan is managed."[349]

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336 *Id.* at 303–06. Bankruptcy Code §§ 1127 and 1144 provide for revocation of confirmation of a plan only if the plan has not been substantially consummated or if the plan was procured by fraud. 11 U.S.C. §§1127, 1144 (2011). If Seven Counties is not able to negotiate a resolution with KERS outside of bankruptcy, it may be required to file bankruptcy again. *See id.*

337 TOBE, *supra* note 1, at 447.

338 Overstreet v. Mayberry, 603 S.W.3d 244, 249 (Ky. 2020).

339 *Id.* at 250.

340 *Id. See also* TOBE, *supra* note 1, 218–54 (discussing KRS's hedge fund investing).

341 *Overstreet*, 603 S.W.3d at 250.

342 *Id.* at 256–66.

343 Spokeo, Inc. v. Robins, 136 S.Ct. 1540, 1545 (2016) (quoting Friends of the Earth, Inc., v. Laidlaw Environmental Sciences (TOC), Inc., 528 U.S. 167, 180–81 (2000)).

344 *Id.*

345 Thole v. U.S. Bank N.A., 140 S. Ct. 1615 (2020).

346 *Id.* at 1618–19.

347 *Id.* at 1620–21.

348 *Id.* at 1619–20.

349 *Id.*

Unlike the situation in *Thole*, the KRS members asserted that the system was at risk of failing.[350] The Kentucky Supreme Court did not find that distinction persuasive.[351] It reasoned that KRS "retirement benefits are part of a statutorily declared 'inviolable contract' between KRS members and the Commonwealth" and that "the Commonwealth has the authority to increase its own contribution to the KRS plan to make up any actuarial shortfall in its assets."[352] The Court further provided "[i]n essence, then, the full faith and credit of the Commonwealth serves as a backstop for Plaintiffs' pension benefits even in the event that severe plan mismanagement renders KRS insolvent."[353]

B. *Political and Legislative Developments*

Kentucky has had a divided government for at least two decades.[354] As of 2020, Kentucky has a Democratic Governor and a divided legislature, with Republicans controlling both the House and the Senate.[355] The Republicans had a "trifecta" from 2017–2019.[356]

Former Governor Matt Bevin tried to close the funding gap by cutting services and by seeking to reduce benefits in the legislation at issue in *Bevin v. Commonwealth*.[357] Governor Andy Beshear, when Attorney General, opposed Bevin in that litigation.[358]

Kentucky has imposed new limits on municipal bankruptcies, effective April 2021.[359] Among other things, a debtor may not be delinquent in its contributions to the retirement system.[360]

In 2020, Republican senators proposed a $1.13 billion budget cut for the teachers' pensions.[361] KTRS pays more than $2 billion per year in benefits, so the operating deficit would widen the funding gap unless there are outsized

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350 *Overstreet*, 603 S.W.3d at 256.

351 *Id.*

352 *Id.* at 253–54.

353 *Id.* at 254.

354 *See* Tom Loftus, *GOP Takes KY House in Historic Shift*, COURIER JOURNAL (Nov. 9, 2016, 7:40 AM), https://www.courier-journal.com/story/news/politics/elections/kentucky/2016/11/08/ control-kentucky-house-up-grabs/93344114/ [https://perma.cc/QU5E-8SGD].

355 *See* Bruce Schreiner, *Republicans Expand Supermajorities in Kentucky Legislature*, ASSOCIATED PRESS (Nov. 4, 2020), https://apnews.com/article/donald-trump-virus-outbreak-legislature-elections-kentucky-9f1f82e787da78ceb6a716eb9bafd295 [https://perma.cc/84Q9-6PG8].

356 *Party Control of Kentucky State Government*, BALLOTPEDIA, https://ballotpedia.org/Party_control_of_Kentucky_state_government [https://perma.cc/27PV-CG3F] (last visited Mar. 30, 2021).

357 *Bevin*, 563 S.W.3d at 78.

358 *Id.* at 77.

359 KY. REV. STAT. ANN. § 66.400.

360 *Id.* at 1(c).

361 Cheves, *supra* note 13.

investment gains.[362] The governor's budget, and that of the Democratic House, would provide $2.4 billion.[363]

C. What Congress Could Do

Kentucky's senior U.S. Senator, Minority Leader Mitch McConnell, weighed in recently, saying he would favor letting states file for bankruptcy.[364] Many see that as code for cutting wages, pensions, and other benefits.[365] Indeed, other politicians have stated that the threat of bankruptcy would make "government employee union bosses" more tractable.[366]

Allowing States to file bankruptcy could also pit public employees against bondholders, as in Detroit and Puerto Rico, leaving both groups more vulnerable. To be sure, that could lead to compromise, but it would likely take a grand bargain, as in Detroit, where the pain is spread among many stakeholder groups.

Congress could rescue public pensions by insuring them through the PBGC or a similar body. That, of course, is precisely what Congress rejected in enacting ERISA, partly because it would be too costly.[367] Indeed, one reason Congress until recently had been hesitant to rescue multiemployer plans is that it could set a precedent for public plans.[368]

Public employees, including those in Kentucky, are generally well educated and politically engaged.[369] But their influence is more likely to be felt at the state level, as the great diversity of plan design, funding levels, and economic conditions may make nationwide reform impossible.

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[362] *See id.*

[363] *Id.*

[364] Steven T. Dennis and William Selway, *McConnell Says He Favors Letting States Declare Bankruptcy*, BLOOMBERG (Apr. 22, 2020, 6:25 PM), https://www.bloomberg.com/news/articles/2020-04-22/mcconnell-says-he-favors-allowing-states-to-declare-bankruptcy [https://perma.cc/745D-92ZC].

[365] *See id.*

[366] Edward Siedle, *Kiss Your State Pension Goodbye*, FORBES (Apr. 23, 2020, 11:10 AM), https://www.forbes.com/sites/edwardsiedle/2020/04/23/kiss-your-state-pension-goodbye/?sh=25d22 7c061f9 [https://perma.cc/V68V-YCAR]. Bankruptcy is a way for states to deal with bondholders and public employee unions. David A. Skeel, Jr., *State Bankruptcy from the Ground Up*, FACULTY SCHOLARSHIP AT PENN LAW, 1–2 (July 19, 2011), https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1370&context=faculty_scholarship [https://perma.cc/R6SQ-PEKE].

[367] *See generally* U.S. DEPT. OF LABOR, HISTORY OF EBSA AND ERISA, https://www.dol.gov/agencies/ebsa/about-ebsa/about-us/history-of-ebsa-and-erisa [https://perma.cc/S2CX-RX3V].

[368] *See* Joshua Gotbaum, *2 Million People Hope Congress Can Compromise on Pensions*, BROOKINGS (Nov. 15, 2018), https://www.brookings.edu/blog/fixgov/2018/11/15/2-million-people-hope-congress-can-compromise-on-pensions/ [https://perma.cc/VW7Y-9NXN]. On March 11, 2021, a multiemployer rescue plan was enacted as part of the American Rescue Plan Act of 2021.

[369] *See* S. Elizabeth Wilborn, *Revisiting the Public/Private Distinction: Employee Monitoring in the Workplace*, 32 GA. L. REV. 825, 866–67 (1998).

VI. Conclusion

Kentucky has taken steps toward making its pensions more sustainable. These funding reforms are consistent with identified best practices. The hybrid plan for new hires is part of a trend of increased risk-sharing, which began in the private sector more than twenty years ago and has since taken hold in the public sector.

But the KTRS remains excluded from reform efforts. For KRS, the reforms will take years to work, and that does not account for the current economic crisis. Moreover, reform imposes current costs on workers and taxpayers, and diminished spending in retirement may slow economic growth for future generations.

Kentucky's progress—and its remaining challenges—exemplify the issues many states, counties, and cities face. Reformers would therefore do well to follow developments in Kentucky.