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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re: CITY OF STOCKTON, CALIFORNIA, Debtor.	Case No. 2012-32118 Chapter 9 D.C. No. OHS-15 **CITY'S RESPONSE TO SUPPLEMENTAL OBJECTION OF FRANKLIN HIGH YIELD TAX-FREE INCOME FUND AND FRANKLIN CALIFORNIA HIGH YIELD MUNICIPAL FUND TO CONFIRMATION OF FIRST AMENDED PLAN FOR THE ADJUSTMENT OF DEBTS OF CITY OF STOCKTON, CALIFORNIA (NOVEMBER 15, 2013)** Date: May 12, 2014 Time: 9:30 a.m. Dept: Courtroom 35 Judge: Hon. Christopher M. Klein

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I. INTRODUCTION

Largely ignoring the bulk of evidence and legal authority cited by the City, Franklin uses its Supplemental Objection[1] instead to reiterate its prior arguments. Essentially, Franklin has its story and is sticking to it. This despite the fact that much of that story is internally inconsistent. Franklin claims in one breath that the City is hiding over a hundred million dollars of future revenue, and in the next that the City will sink back into bankruptcy under the weight of its pension obligations. Franklin decries the City's Long-Range Financial Plan for not using the same assumptions as the City did for the last fifteen years, but argues that the calculation of retiree health benefit claims should be solely forward-looking. The list goes on. As discussed in this Response, Franklin's many criticisms[2] of the City's proposed plan of adjustment and financial projections are baseless. The Plan provides a path for the City to return to cash solvency, budget solvency, and service solvency, while treating its creditors – the vast majority of whom have reached deals with the City – fairly. Meanwhile, the City's financial projections are based on proper methods and data, and show how the City will remain sustainable by utilizing appropriate assumptions and safeguards that were lacking in the lead-up to the City's bankruptcy. As demonstrated in this Response and in the City's prior briefs, the Plan should be confirmed.

II. THE CITY'S LONG-RANGE FINANCIAL PLAN IS ACCURATE AND REASONABLE.

The crux of Franklin's "Best Interests" argument is that the City, contrary to its projections, will be awash with tens of millions of dollars with which it can pay Franklin. Franklin's expert on this issue, Charles Moore ("Moore"), at various points misinterprets, misrepresents, and miscalculates portions of the City's Long-Range Financial Plan ("LRFP") in support of his contention that the City is hoarding money. Despite having no experience

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[1] Supplemental Objection Of Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund To Confirmation Of First Amended Plan Of Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) [Dkt. No. 1377], hereinafter referred to as the "Supplemental Objection" or "Supp. Obj.".

[2] This Response does not reply to every individual allegation raised by Franklin, many of which have already been addressed in the City's Supplemental Memorandum Of Law In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) [Dkt. No. 1309] ("City's Supplemental Brief") and will be further addressed at trial. Instead, this Response focuses on the most egregious inaccuracies in the Supplemental Objection.

managing local governments, Moore suggests that the City can base its projections on the extreme boom and bust cycle of the last fifteen years, and that the City should maintain the same margins that it did in the years leading up to its insolvency. Moore criticizes various assumptions and decisions made by the City in creating the LRFP, but offers no alternatives for providing for the City's long-term security, other than to pay Franklin. As always, it is easy to cast stones, and much more difficult to make hard decisions about how to pull a city out of bankruptcy and set it on a path towards feasibility over the next 30 years. Even more telling is the fact that Moore faults the City for including provisions in the LRFP that Moore's own firm has included in the financial plan for the City of Detroit.

As demonstrated below and in the declarations of those with direct experience with the City's finances, the City's LRFP provides reasonable, accurate projections of the City's finances over three decades. Those projections account for the City's present condition, rather than assuming that the City will (or should) continue its prior boom and bust cycle, while also including necessary and appropriate reserves that were previously lacking as a safety measure against future recessions and economic variations. Franklin's assertion that the City should do away with these safeguards and assume the same revenue growth as in the years leading up to the recession is a return to the way of thinking that led the City into bankruptcy in the first place.

A. **The LRFP Properly Provides For An Unrestricted Reserve Fund And An Annual Contingency To Guard Against Cash Insolvency And Budget Insolvency In The Future.**

Moore criticizes the LRFP for containing both a 16.67% unrestricted reserve fund and a $2 million annual contingency. According to Moore, a 16.67% reserve fund is too high, and the annual contingency is completely unnecessary. To the contrary, both the reserve fund and annual contingency are vital aspects of the City's future feasibility. *See* Direct Testimony Declaration of Robert Leland In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) ("Leland DTD"), ¶¶ 11-17, 23-26; Direct Testimony Declaration of Robert Deis In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) ("Deis DTD"), ¶ 28.

As described in the Leland DTD, the Government Finance Officers Association's best practices call for cities to maintain two months, or 16.67%, of total expenditures in unrestricted fund balance. Leland DTD, ¶ 11. While Moore cites the fact that the City maintained unrestricted fund reserves in the past of only 5% and 10%, *see* Supp. Obj., at 11-12, the recent recession made clear that such reserves were inadequate. Leland DTD, ¶ 12. Nevertheless, Franklin asserts that an unrestricted fund reserve of 10%, or less, should be sufficient, and that any additional money is available to pay Franklin. This position appears to misconstrue the nature and purpose of an unreserved fund reserve, which is meant to act as a one-time resource to address short-term crises or unexpected expenditures, and is not available to pay an ongoing increase in obligations or loss of revenues. *Id.* ¶ 13. Maintaining the GFOA's recommended reserve minimizes the prospects of the City suffering cash insolvency in the future.

Meanwhile, it is the annual contingency that provides a *long-term* buffer against economic fluctuations. Leland DTD, ¶¶ 14, 23-26. Thus, the annual contingency minimizes the prospects of the City suffering budget insolvency in the future. Prolonged economic downturns can cause shortfalls of tens of millions of dollars over several years, which would quickly erase a two-month fund balance. *Id.* The annual contingency protects against these longer-term economic slumps by spreading their impact over the entire term of the LRFP. *Id.* Equally important, the annual contingency also provides protection against future variations from the projections. Every budget strives for accuracy, but the simple fact is that no one can predict the future perfectly. While the LRFP is based on reasonable and well-supported assumptions, the City must assume that reality will differ from its projections. *Id.* ¶ 23. And of course, the longer the forecast, the greater the potential variability. *Id.* The cumulative nature of the annual contingency is appropriate given the greater uncertainties inherent in projections that reach decades into the future, and given the increase in the magnitude of the City's obligations as they grow over the period of the LRFP. The annual contingency provides a "smoothing" mechanism that guards against deviations from the LRFP actually experienced by the City.

Nevertheless, Moore purports to calculate scenarios showing that the City can increase payments to Franklin by eliminating the fiscal safety protocols represented by the annual contingency and unrestricted fund reserves. Moore advocates that unrestricted fund reserves be maintained at a level as low as 5% and that the annual contingencies be eliminated in favor of greater payments to Franklin, in effect removing the buffers against future cash and budget insolvency. Supp. Obj., at 11. This approach completely ignores the fact that the City's 10% reserve alone was completely inadequate to stave off bankruptcy. Leland DTD, ¶ 25. Moreover, the City will not even reach its target 16.7% unrestricted fund reserve level for another nineteen years (in FY 2033-34). *Id.* ¶ 12. If the City eliminated its annual contingency and lowered its reserve in order to pay Franklin, the City would have essentially no protection against the next downturn. Under current projections, the City's General Fund balance would "rapidly erode and result in a deficit within 7-9 years, depending on the timing and severity of recessions," which would require yet another restructuring. *Id.* ¶ 15. This is not in the best interest of the City, its creditors, or its citizens. The City must be sustainable, and the provision for an unrestricted fund balance and an annual contingency in the LRFP is the accepted and responsible way to achieve such sustainability. As the City's former City Manager, Robert Deis ("Deis") explains:

> When planning a General Fund budget over multiple years, city governments must set aside funds – in the form of unrestricted fund balances, annual contingencies, and other mechanisms – to protect against unexpected, and often catastrophic, events, such as uninsured lawsuits, floods, economic crashes, etc. The City's inclusion of these items in its LRFP is good business.

Deis DTD, ¶ 28.

In addition to ignoring the basic purpose of the reserve and annual contingency, Moore also vastly exaggerates their size. Moore misleadingly claims that the reserve and annual contingency included in the LRFP will leave the City with "a cash reserve of <u>29.8%</u> of its expenditures by the end of the Long-Range Financial Plan." Supp. Obj., at 13 (emphasis in original). This assertion is seriously flawed. First, it assumes that the City will *never* have a down year and never need to spend one penny of its reserve or contingency. This hypothetical three-decade stretch in which the City never sees a rainy day grossly skews reality. Second, Moore reaches this inflated figure by comparing the reserve and contingency projections over the *entire* 30-year term of the LRFP to a *single* year of expenditures. When properly viewed in the context of the full 30 years of projections, the combined reserve and annual contingency amount to a mere 1.4% of the City's expenditures over that period.[3] *See* Ex. B to the Disclosure Statement, as modified by City's Trial Exhibits 3034 and 3035 (revised Attachments A and A-1 to the LRFP, current as of March 2, 2014). This means that if the City's projections over 30 years are off by just one and one-half percent, the City's entire reserve and contingency will be erased. *See* Deis DTD, ¶ 28 ("If staff was short just 1 percent in revenues and 1 percent over in expenditures in a given year . . . the annual contingency will be more than consumed."). A mere 1.4% safeguard over three decades is far from excessive. To the contrary, it is a relatively small margin for error.

Finally, it is particularly notable that the Plan of Adjustment for the City of Detroit, which is represented by Moore's firm and for which Moore is the lead of the team providing operational restructuring services, contains the same annual contingency that he attacks Stockton for including in its LRFP. Leland DTD, ¶ 24; Moore Report[4], at 2. The Detroit Plan includes an annual contingency of approximately 1% of the total of its operating expenditures, restructuring costs, secured claim payments, and debt service, which is roughly the same percentage as the contingency provided in the LRFP. Leland DTD, ¶¶ 23-24. The Detroit Plan also contains an unfunded reserve, though it amounts to only around 7-8% of that City's total expenditures, well below the GFOA's recommendation. *Id.*, ¶ 24. As Moore testified during his deposition when asked about the Detroit Plan:

> Q: If you used aggressive assumptions for such things as income, how would you handle the chance that there might be an economic downturn during that ten year period?
>
> A: Well, we have two items. The first, the contingency relates to where we think we are going to be off in these projections, and the contingency is meant to address where we think we are going to be off. Separately we have I have [sic] minimum fund balance that we maintain as well. And so between those two items, that provides the City [Detroit] a cushion for an economic downturn.

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[3] Similarly, the combined reserve and contingency amounts to 1.4% of City revenues over the same period, and only 0.7% of the total budget.

[4] Submission By Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund Of Expert Report Of Charles M. Moore [Dkt. No. 1293], Ex. A (hereinafter the "Moore Report").

Direct Testimony Declaration of Patrick Bocash In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) ("Bocash DTD"), Ex. K (Portion of rough transcript of deposition of Charles Moore), at 81:24-82:10. Moore's assertion that the "inclusion of both a contingency and a minimum cash cushion is redundant and not necessary", Supp. Obj., at 12 (emphasis in original) is thus meritless. When Moore's own firm was faced with the challenge of ensuring a city's long-term feasibility, it made the same decision that Stockton did.

B. The LRFP's Projections are Reasonable And Realistic, And Account For The Inherent Uncertainty Of Long-Term Forecasts.

Franklin makes much of the fact that the LRFP describes itself as "conservative." *See, e.g.*, Supp. Obj., at 7. In doing so, Franklin misinterprets this term. The LRFP is not "conservative" in the sense of low-balling its projections, as Franklin would have the Court believe, but rather in the sense that its projections and assumptions are pragmatic. *See* Leland DTD, ¶ 22. That is, the forecast is "conservative" as compared to the wildly optimistic projections the City engaged in during the last decade and a half. As Leland explains:

> In preparing the LRFP, the City considered as many contingencies as possible in order to develop the most realistic revenue and expense projections that it could to demonstrate solvency over a prolonged period of time. Its revenue and expense projections are conservative relative to the pre-recession magnitude of estimates that got the City into trouble in the first place, but grounded in post-recession reality.

Leland DTD, ¶ 3. This is as it should be, as it was this unjustifiably exuberant approach to forecasting that pushed the City into bankruptcy. Cities must make realistic and responsible projections, and cannot, as Moore would urge the City to do, assume the best case scenario.

This does not mean that the projections in the LRFP have nowhere to go but up. To the contrary, the LRFP represents the City's best estimate of its future finances in light of its post-recession economic reality, while still accounting for the fact that the City must be able to weather future economic downturns and the inherent uncertainty of projections extending out three decades. In fact, the very portion of the LRFP cited by Franklin as touting the projections as "conservative" expressly states that "the forecast is *prudently* conservative but *still subject to* *risks based on assumptions made*." LRFP, at 2 (emphasis added). Rather than read the LRFP's discussion as a whole, Franklin chooses to cherry-pick the term "conservative" and misrepresent it as evidence that the City is hiding money. This is simply not the case. The LRFP is conservative in the way a responsible City's budget forecasting should be. *See* Leland DTD, ¶¶ 3-10, 22; Deis DTD, ¶ 24 ("The LRFP's projections are appropriately conservative, as the City cannot risk the excessive optimism that caused it to collapse into bankruptcy in the first place.").

Nevertheless, Franklin and Moore repeatedly attack the methodologies employed by the LRFP. For instance, Moore criticizes the LRFP on the basis that it projects lower revenues than those experienced over the last fifteen years. Supp. Obj., at 7. But it would be foolhardy for the City to assume that the next 15 years will mirror the last. Deis DTD, ¶ 24. The past decade and a half are an inappropriate basis for projecting the City's future revenues for a host of reasons, all of which Moore ignores. Leland DTD, ¶ 22 (describing in detail factors critical to the projection of property tax, sales tax, and utility user tax revenues). For instance, Moore neglects the fact that past property tax revenues were inflated by loose credit standards that no longer exist, as well as a one-time settlement of $3 million received from San Joaquin County. *Id.* Nor does Moore consider the effect of California propositions that will suppress property tax revenues for years to come. *Id.* Similarly, Moore's projections for sales tax revenue fail to take account of short-term bumps resulting from pent-up demand and a one-time "triple flip" adjustment from the State, while ignoring potential losses of sales tax revenue from online retailers. *Id.* Moore does not acknowledge *any* of the factors discussed in the Leland DTD, relying instead on the bare assertion that the past 15 years are an accurate model for the City moving forward because that period "includes a full economic cycle containing both an *abnormal* boom and a *severe* financial crisis." Moore Report, at 4 (emphasis added). This is hardly a sound basis for projecting the City's future. The City cannot ignore its post-recession position, and the LRFP properly assumes that the City must live within a lower rate of revenue growth than it has in the past. As described by Leland:

> The City employs a forward-looking approach that incorporates data relevant to the estimation of future revenues, rather than relying on an historical average rate of growth that is biased by the

> "irrational exuberance" of the pre-recession housing bubble, followed by the worst recession since the 1930's, which also includes unique biases relative to each of the three major revenue sources that a more careful review would have uncovered. The City's revenue estimates are realistic and do not eliminate the downside risk of reduced revenues in the event of economic downturns.

Leland DTD, ¶ 22.d.

Moore also claims that "in an accurately-forecast budget, over time any negative variances and positive variances should net out," thus leaving the entirety of the City's reserve and annual contingency available to pay Franklin. Supp. Obj., at 9. Again, Moore discusses the LRFP's "accuracy" as if it was an audit of past financial results, rather than a prediction of an uncertain future. The reserve fund and annual contingency are necessary precisely because the City (and Moore) cannot know exactly what will happen over the next 30 years,[5] and it is possible that the City's projections will not be met. In Leland's words:

> The LRFP is based on reasonable and realistic assumptions, but there is no guarantee that the forecast will in all respects be met, every year, for 30 years. The reality is that revenues and expenditures will deviate from the forecast. The purpose of the contingency, as explained in paragraphs 14 and 15, is to provide a "smoothing" mechanism, or buffer, against these future variations. These changes to base revenues and expenditures will compound over time, so the longer the forecast, the higher the potential volatility. Building in an annual $2 million contingency, the equivalent of about 1% of total expenditures, spreads the impacts of economic downturns over the entire period of the LRFP. This allows the City to make projections of its future finances without having to make predictions about the specific timing or severity of future recessions.

Leland DTD, ¶ 23. Moreover, even if some up and down periods offset over the next 30 years, there may still be periods where the City is short millions of dollars over several years. Without a buffer during those down periods, the City would again suffer budget insolvency and fall right back into bankruptcy:

> As evidenced by the recent recession, economic downturns can cause a city to fall short of its projections by millions, or even tens of millions, of dollars over several years. Moreover, it may take several additional years for a city's revenues to return to their prior

[5] The City of Vallejo only forecast a five-year planning horizon, while the City of Detroit, Moore's client, is looking at a ten-year period. Deis DTD ¶ 27; Leland DTD ¶ 39.

> peak year total, much less the level to which revenues would have grown given a continuation of pre-recession trends. . . . The annual contingency is meant to provide a safeguard against these types of long-term setbacks by serving as a "smoothing" mechanism – that is, the annual contingency spreads the impacts of economic downturns over the entire period of the LRFP.

Id. ¶ 14. The City's Plan cannot simply do away with appropriate buffering mechanisms dictated by sound fiscal policy concerns on the notion that everything will even out over time.[6]

Moore also takes issue with the portion of the LRFP projections set aside for "mission critical" spending. Supp. Obj., at 12. The forecast shows amounts in excess of the reserve requirement as the City's capacity to spend on items in excess of the baseline, such as deferred maintenance, capital improvements, increased staff to respond to workload increases, and restoring decreased services. These items are not luxuries, but instead are needed to restore the City's service delivery solvency. They represent important expenditures that will eventually have to be undertaken in order to make up for the cuts the City has imposed to make ends meet. In its Opinion Regarding Chapter 9 Order For Relief, 493 B.R. 772 (2013), the Court found that the City was service delivery insolvent, in addition to being cash insolvent and budget insolvent. *Id.* at 790-791. Thus, in order to get the City back on its feet, the Plan must help to restore the City's services, as well as balance its books. Deis DTD, ¶ 21. As stated by Deis:

> In addition to putting the City on a path of cash and budget solvency, the Plan also allows the City to restore its service solvency. The most critical issue that had to be addressed from a service solvency standpoint was the City's crime problem, both real and perceived. The City's reputation for unsafe streets has seriously impacted business investment in the City, as well as citizens' perception of personal safety. . . .While the City's fire, library, public works and recreation programs also have suffered enormous cuts, the City's recovery under the Plan, though slow, will allow the eventual restoration of some (but not all) of these services.

Deis DTD, ¶ 33. Nor is the "mission critical" item in the LRFP the treasure trove Moore suggests it is. For one, the City will not achieve the best practices reserve level of 16.67% until FY 2033-

[6] To the extent Franklin complains that the City might do better than its projections, "the gain-sharing approach of the contingent payments agreement that the City negotiated with Assured Guaranty under the auspices of Judge Perris, rather than the elimination of the forecast contingency or the spend-down of reserves, is the less risky and more appropriate approach to the payment of creditors." Leland DTD, ¶ 26.

34, and thus will not have any "extra" mission critical funds for almost 20 years. Leland DTD, ¶ 12. Even then, over the term of the LRFP, mission critical expenditures represent only a 3% increase in total expenditures.

Franklin also asserts that the LRFP's projections are too low because the City's General Fund came in ahead of projections in FY 2012-13, and the City subsequently amended its property tax revenue budget. However, Franklin overstates the meaningfulness of this action. As Leland explains:

> Moore's statement that the Council's action on February 25, 2014 to increase the property tax estimate for FY2013-14 shows the City's growth numbers are conservative is mistaken. The higher revenue in 2013-14 is not an indication that ongoing growth will be higher, only that assessed value increases are starting *sooner* than previously expected.

Leland DTD, ¶ 22.a (emphasis in original). Moreover, the updated figures that Leland and the City provided to Franklin in early March *already take these new results into account*. Leland re-ran the projections in Exhibit A to the LRFP on March 2, 2014, and the City produced the new results to Franklin on March 3, 2014. *See* Supp. Obj., at 2 (referring to the "revised" Exhibit B to the Disclosure Statement); Leland DTD, ¶ 7; City's Trial Exs. 3034 and 3035. As those updated figures show, the long-term impact of the FY 2013-14 changes cited by Franklin are minimal, a fact that Franklin conveniently omits.[7]

The LRFP relies on proper methodologies and lays out a step-by-step analysis of how the City can achieve cash, budget, service, and long-term solvency under the Plan. *See* Deis DTD, ¶ 19, 24-28, 33-35. Contrary to Franklin's implications, the City cannot simply cut away various items in the LRFP and thereby create money it can use to pay Franklin. Because Stockton's recovery from the recession remains slow, the LRFP necessarily maintains relatively low margins, even with its buffering mechanisms. Moreover, the City's reserves and services will have to be restored gradually, over a period of many years. Franklin's criticisms of the LRFP

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[7] It is particularly misleading for Franklin to suggest that Leland somehow "changed" his testimony at his deposition due to reading the Moore Report, given that the Moore Report was submitted 19 days after the deposition cited by Franklin. *See* Supp. Obj., at 8.

notwithstanding, the LRFP's forecast has a sound basis and provides a reasonable, accurate projection of the City's economic performance under the Plan.

C. <u>PFF Revenues Are Not Available To Pay Creditors.</u>

Franklin continues to insist that the City can pay Franklin's claim, in full, from PFF revenues that do not exist. Supp. Obj., at 14-20. Franklin argues that the City's PFF funds can be expected to be generated from at least 600-700 new housing units annually, and that essentially all of the PFFs from that new development can be used to pay Franklin rather than to invest in new infrastructure for that new development (as expected by the developers that pay the PFFs). *Id.*, at 16-17. In order to reach this conclusion, Franklin shrugs off the fact that the City issued less than 100 permits in the last calendar year, and claims, without any support, that the City can be expected, someday, to return to its pre-bankruptcy PFF revenues. *See* Direct Testimony Declaration of Stephen Chase In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) ("Chase DTD"), ¶ 13. Franklin also ignores the many factors that did not exist prior to the City's bankruptcy that will continue to suppress PFFs for the foreseeable future. Further, even if there were PFF revenues available, there are other obligations to which the City must apply PFF revenues.

First, most of the PFF money collected by the City must be used to pay for projects that mitigate growth as defined by the AB 1600 study adopted by the City pursuant to state law. Chase DTD, ¶¶ 2-6; Leland DTD, ¶ 27. The California Mitigation Fee Act of 1987, also known as "AB 1600," requires that the study establish a "nexus" between the PFFs and the level of service or infrastructure costs. As the City's Director of Community Development, Stephen Chase ("Chase"), explains:

> [T]he Act [AB 1600] requires that there be a "nexus" between the level of service and/or infrastructure costs and the fee charged. In order to establish the nexus for a new PFF, the City must identify the purpose of the fee, identify the use to which the fee is to be put, and determine how there is a reasonable relationship between the fee's use and the type of development project on which the fee is imposed. These findings are contained in a fee study prepared by or for the Community Development Department and the Administrative Services Department and submitted to the City Council for approval.

> Because of the Act's nexus requirement, the permissible uses of PFF receipts are restricted to the purposes for which the PFFs were imposed—in other words, the purposes set forth in the fee study that was required to be undertaken by the City in order to levy the charges.

Chase DTD, ¶¶ 3-4; Leland DTD, ¶ 27. Due to this "nexus" requirement, PFF receipts can be used *only* for the purposes for which the PFF was imposed. Chase DTD, ¶ 4. Developers who pay PFFs thus expect these projects to be funded, and can legally challenge PFF levels if necessary funding is not set aside within five years. Leland DTD, ¶ 27. As a result, by law, only certain PFF funds can legally be used to reimburse the General Fund for lease payments on the 2009 Golf Course/Park Bonds. As described by Chase:

> The proceeds of the 2009 Golf Course/Park Bonds funded certain infrastructure improvements that would have otherwise been eligible for funding from certain PFF funds. Because of this, the PFF funds from which the improvements would have otherwise been eligible for funding may reimburse the General Fund for the portions of the lease payments on the principal of (but not interest[8] on . . .) the 2009 Golf Course/Park Bonds that are allocable to those improvements. The authority to use PFF receipts to refund the principal payments on the 2009 Golf Course/Park Bonds is based on the use of bond proceeds to finance fee-eligible improvements.

Chase DTD, ¶ 7.

Moreover, the City is not *required* to use PFF funds to reimburse the General Fund principal payments; it is merely an option. Chase DTD, ¶ 8. It is not a practical option, however, because the City's ability to use PFF receipts to refund these principal payments, even from these specific funds, is still limited by the City's obligations to use PFFs to pay for new infrastructure from these funds. For instance, the City's Capital Improvement Program for FY 2013-14 through FY 2017-18 identifies $440 million in unfunded transportation projects, a significant portion of which will have to be paid out of the Streets PFF fund. Chase DTD, ¶ 11; Leland DTD, ¶ 27. Similarly, the General Plan standard park acreage per 1000 residents imposes a new park construction cost that alone is in excess of what 700 housing units per year would generate in PFF

[8] Franklin contends that the City's stated inability to use PFFs to make payments on interest is "patently false." Supp. Obj., at 14. To the contrary, this limitation is based on the fact that "the fee study for the projects funded by the proceeds of the 2009 Golf Course/Park Bonds did not establish fees in an amount designed to cover interest carried on the cost of the improvements." Chase DTD ¶ 10. As a result, PFFs cannot legally be used to refund the General Fund for payments for the interest component of the amounts due under those bonds. *Id.*

income. Chase DTD, ¶ 19; Leland DTD, ¶ 27. The fundamental purpose of PFFs is to fund improvements that mitigate the impacts of new development. *Id.* ¶ 9. The City thus cannot simply hand over every dollar it receives in PFFs to creditors, otherwise it would be unable to pay for the infrastructure that serves the new developments generating the fees. *Id.*

Furthermore, the City can spend only those PFF revenues that it actually receives. PFF revenues have slowed to a trickle since the boom years, when development permits for residential dwellings reached an average of almost 3,000 per year, preceding the recent recession. By contrast, from FY 2008-09 through FY 2011-12, the City has issued an average of only 135 residential dwelling permits per year. Chase DTD, ¶ 13. In the last calendar year, the City issued only 97 dwelling permits, and thus far in FY 2013-14 the City has issued a scant 64 such permits. *Id.*, ¶¶ 13-14. As a result, the Police and Fire PFF funds are collectively $3.7 million in deficit, and must be repaid before there can be any "excess" PFFs for Franklin. *Id.* ¶ 13.

Franklin's contention that the City will have more than enough PFFs to pay Franklin's claim rests on a forecast by Economic & Planning Systems ("EPS") that has subsequently proved to be inaccurate. In June 2013, based on the information available at the time, EPS projected that the City would be issuing roughly 700 units per year by 2017. Chase DTD, ¶ 14. While Franklin is quick to cite this number, *see* Supp. Obj., at 17, the unfortunate reality is that the increases expected by this projection have not come to pass. To date, the City is on pace to issue the fewest annual dwelling permits in recent memory. Chase DTD, ¶ 14.

Franklin also misleadingly states that the "Long-Range Financial Plan itself 'assumes a conservative $500,000 in available PFF revenues' annually for the payment of debt service on the [sic] Franklin's Bonds." Supp. Obj., at 14. This is not accurate, as Franklin well knows. As Leland explained in his deposition, the LRFP only projects revenues for the General Fund and does not project any non-General Fund revenues. However, Exhibit A to the LRFP is a spreadsheet that calculates the savings to the General Fund resulting from the financial restructuring of the City's financial obligations. When that spreadsheet was prepared in the summer of 2013, it included an assumed amount of $500,000 in PFF revenues that had been devoted to payment of the $2.9 million annual debt service on the Golf Course/Park Lease payments. The savings to the General Fund of the City rejecting the Golf Course/Park Leases was therefore included in that spreadsheet in the amount of only $2.4 million to account for the $500,000 of PFF revenues that had previously been available to help pay those lease payments. The $500,000 figure mentioned in Exhibit A to the LRFP is what the City had *previously* assumed would be available from PFFs. Leland DTD, ¶¶ 6-8; Franklin's Trial Ex. 2630 (Designations from Transcript of Deposition of Robert Leland), at 154:17-156:15. Thus, the $500,000 referenced by Franklin is shown as a one-time deduction to the General Fund’s savings on debt service, and *not* as an available source of PFFs into the future. *Id.* Leland explained the above at his deposition and further clarified that the LRFP did not contain any forward-looking projections of PFF revenues. Yet in its Supplemental Objection, Franklin still makes the empty assertion that the LRFP projects that there will be $500,000 of PFF revenues available in the future for payment to Franklin. This is not and never has been the case.

Furthermore, a number of factors exist that are likely to inhibit the growth of PFFs going forward. For one, the economic conditions on which the 700 unit-per-year projection was based have not occurred. As Chase explains:

> The EPS projection of 700 units per year was dependent on certain economic factors being met, such as a drop in unemployment and increase in the price point for home sales. Unemployment in Stockton remains high as of February 2014, at 15.9%, and job formation remains slow. Further, price points for new homes remain closer to the $200,000 level, not $300,000. . . . The City’s financial consultants forecast that economic conditions in Stockton will remain depressed for years to come.

Id. ¶ 15. Another impediment to future PFF growth is the required overhaul of the City’s General Plan and Capital Improvement Program. *Id.* ¶ 16. The 2035 General Plan, under which the City operates, was promulgated in December 2007 and therefore does not reflect present economic conditions. *Id.* ¶¶ 16-17. Nor does it reflect new state mandates that will limit PFF revenues by requiring a greater ratio of infill to greenfield development. *Id.* ¶ 17. Finally, it is unlikely that the City will be able to raise the amount of PFF fees imposed on developers due to what Chase describes as the “the intense political pressure in Stockton to reduce PFFs and other developer fees in an effort to encourage development:”

> Development is essential to the City's recovery following bankruptcy. Many citizens, among them a number of influential and well-financed developers, believe that to encourage development it is necessary to reduce the amount of fees imposed on new development. The City reduced the Streets PFF rate by half in 2010 as an incentive for development, with the discount scheduled to end on December 3, 2013. However, the City Council extended that 50% rate discount for another year, through December 31, 2014. Because revenue foregone through rate discounts cannot legally be made up through higher levies on future development, these four years of lost revenue cannot be regained. And the political pressure is ongoing: The City's Strategic Initiative III.3 provides policy direction to simplify and reduce development impact fees, so as to stimulate economic development.

Id. ¶ 20. Based on these factors, and on the slow pace of Stockton's recovery, PFF revenues are projected to remain extremely low for the foreseeable future. As a result, Franklin's assertion that the City's PFF revenues will surely pick up is uninformed and dubious at best.

Franklin ignores the unfavorable reality of the City's PFF revenues in favor of a 10-month-old report that has been demonstrably disproven by intervening events. The City, however, must deal in facts. PFF revenues are minimal, likely to remain low, and legally obligated to numerous other uses before they can be paid to Franklin.

III. FRANKLIN'S UNSECURED DEFICIENCY CLAIM IS PROPERLY CLASSIFIED AND NOT SUBJECT TO DISPARATE TREATMENT

Just as Franklin's Lease Rejection Claim was properly classified as an unsecured claim under the Plan, Franklin's unsecured deficiency claim resulting from the entry of the Partial Judgment In Favor Of Plaintiffs [Dkt. No. 56] in the Adversary Proceeding, to the extent that it is allowable, is similarly an unsecured claim for all of the reasons set forth in the City's Supplemental Brief.

Franklin doggedly maintains that the Court should deal with the Plan's treatment of creditors, rather than claims. Franklin continues to complain that the Retiree Health Benefit Claimants receive between 53% and 70% on their claims because "as a quid pro quo for the sub-1% 'settlement' of Retiree Health Benefit Claims, the City agreed to leave pensions fully unimpaired." Suppl. Obj., at 30. Franklin ignores that the City determined to leave pensions unimpaired independently of, and long before, its settlement with the Retirees Committee. In fact, the City's negotiated deals with its unions, which preceded the Retirees Settlement, were based in part on the City maintaining its pensions. *See, e.g.*, Direct Testimony Declaration of Ann Goodrich In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) ("Goodrich DTD"), Ex. A. Thus, by the time of the Retiree Settlement, it was already established that the City intended to provide the Retiree Health Benefit Claimants, and all other City employees and City retirees,[9] with pension benefits. Though the City provided the Retirees Committee with confirmation of that fact, the City's decision to maintain its pension obligations was made long ago, and thus could not be a quid pro quo for the Retirees Settlement. The Plan does not provide, for example, that the Retiree Health Benefit Claimants will lose their pension benefits, or have them reduced, if they fail to vote for the Plan. Thus, despite the link that Franklin attempts to find between the Class 12 Claims of the Retiree Health Benefit Claimants and their pension benefits, there is no basis for lumping in or conflating non-Class 12 recoveries of the Retiree Health Benefit Claimants with their Class 12 recoveries. The Plan provides treatment for classes of Claims and not for classes of creditors, as Franklin maintains.

Consistent with its incorrect theory that Class 12 includes all of the different claims of the Retiree Health Benefit Claimants, Franklin continues to cite cases involving disparate treatment to holders of claims in a single class as authority for its flawed arguments. None of these cases hold that plan treatment of a class of claims must necessarily include recovery on other claims held by members of the class, as Franklin asserts with respect to the Retiree Health Benefit Claimants. In fact, such cases typically hold that the problem lies with providing holders of claims in a single class with disparate treatment *on account of their claims in that particular class*, depending upon whether holder of claims in that class vote for the plan or not.[10]

Had the City classified the claims of the pension benefits of the Retiree Health Benefit Claimants in Class 12 along with the Retiree Health Benefit Claims, Franklin might have an argument. However, the fact that the City confirmed its pre-existing decision that pension

[9] Retirees that were not promised the health benefits also retain their pension benefits.
[10] *See* City's Supplemental Brief, at 9-10.

benefits of the Retiree Health Benefit Claimants would be treated the same as all other City employees and City retirees does not drag those claims into Class 12, as Franklin contends.

Franklin argues that its claim cannot be classified with the Retiree Health Benefit Claims because the two sets of claims are fundamentally different in that Franklin's claim can be paid with PFFs while the Retiree Health Benefit Claims cannot, and that the Retiree Health Benefit Claims can be paid from restricted funds while the Franklin Claims cannot. Supp. Obj., at 27. This is no distinction, because neither group has any *binding* claims on such funds. The Retiree Health Benefit Claimants cannot require that they be paid with restricted funds, just as Franklin cannot require that Franklin be paid with PFFs. The City merely has the option to use PFFs in making payments on the Franklin claims and to use restricted funds in making payment on the Retiree Health Benefit Claims, should the City's other obligations on these funds allow it. The City's source of funding for making such payments does not change the fundamental nature of the two sets of claims. Thus, when Franklin argues that the *Loop 76*[11] case mandates separate classification of the Franklin claims, it ignores the fact that Franklin does not have an independent source of recovery such as the guaranty available to the creditor in *Loop 76*. Supp. Obj., at 27.

Finally, Franklin asks the Court to determine the merits of claims asserted by Assured—namely, that Assured is entitled to full payment on the Pension Obligation Bonds—by providing the Court with two paragraphs of legal argument and a citation to the Pension Obligation Bond offering documents to the effect that CalPERS is not liable for repayment of the Pension Obligation Bonds (as if the liability of CalPERS on the Pension Obligation Bonds were relevant). Suppl. Obj., at 28-29. Notwithstanding this attempt to summarily dismiss Assured's claims of entitlement to full payment when Franklin has nothing at stake in the matter, the City, which was facing the possibility of full payment of a claim in excess of \$125 million, could not be so cavalier in its evaluation of the matter and decided to settle with Assured. Thus, Franklin's unsecured deficiency claim has a different legal character than that of the Pension Obligation Bonds, and the City has a legitimate business reason for separate classification of the same.

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[11] *Wells Fargo Bank, N.A. v. Loop 76, LLC (In re Loop 76, LLC)* 465 B.R. 525 (9th Cir. BAP 2012).

IV. THE PLAN DOES NOT UNFAIRLY DISCRIMINATE BETWEEN FRANKLIN'S CLAIM AND ANY SIMILARLY SITUATED CLAIMS

As pointed out in the City's Supplemental Brief at pages 17 and 18, Franklin confuses cram down analysis with classification analysis. Franklin is a holder of a claim in an accepting class, and Franklin is properly classified in that class. As a result, the unfair discrimination confirmation standard is not applicable. Nevertheless, Franklin continues to assert that its unsecured deficiency claim is no different than the "unsecured" claims of the capital markets creditors that receive a greater percentage recovery under the Plan and that Franklin should achieve the same level of recovery. Suppl. Obj., at 32-33. These arguments are incorrect for the reasons set forth in the City's Supplemental Brief.

However, Franklin now raises an additional argument that the City paid its prepetition trade vendors and service providers. The City of course determined that payment of such claims was necessary to avoid costly disruptions in the operations of the City during its chapter 9 case. As the City's Chief Financial Officer, Treasurer, and Administrative Services Department Director, Vanessa Burke, explains:

> To the best of its knowledge, the City is paying all of its post-petition debts as they become due. If it did not, the City would no longer be able to operate. If the City did not meet its payroll obligations as they become due, for example, City employees would likely cease coming to work. If the City did not pay its vendors, they would no longer do business with the City. In sum, if the City were not to pay its current bills as they became due, it would be unable to provide basic services to the residents of Stockton. Franklin's allegation that the City's payment of such debts unfairly discriminates against Franklin reflects a fundamental misunderstanding of the City's function. Contrary to what Franklin may believe, the City is not run for Franklin's benefit. It is run for the benefit of its citizens.

Direct Testimony Declaration Of Vanessa Burke In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013), ¶ 6. Because the City was generally current in payment of its vendors and service providers before filing its chapter 9 case, the amounts involved are only incidental. In any event, those claims are not treated under the Plan, so Franklin can hardly claim that unfair discrimination exists between the two sets of claims.

The City has valid and legitimate business reasons for the treatment of the claims of the other capital markets creditors, which in any event are dissimilar in their legal character.

V. THE LRFP ADEQUATELY ACCOUNTS FOR THE CITY'S PENSION OBLIGATIONS

A. Franklin's Criticisms Of The City's Pension Projections Are Misplaced.

Throughout most of its briefing, Franklin claims that the City will have *more* cash than it is letting on, and will have excess cash to pay Franklin. Yet this has not stopped Franklin and its expert, Moore, from simultaneously claiming that the City's CalPERS obligations "pose a clear and present danger to the City's future viability" and "could call the feasibility of the Plan and future viability of the City into question." Franklin Reply to CalPERS Brief Regarding Pension Liabilities [Dkt. No. 1397], at 1; Moore Report, at 21. According to Moore, the City's pension obligations are "very high, growing, and unpredictable." Moore Report, at 18. Moore goes on to state that these obligations are in fact "unsustainably high." *Id.* at 21. While there is no doubt that the City's CalPERS obligations are substantial, the fundamental point that Franklin and Moore overlook is that these costs are already factored into the LRFP, and the LRFP allows for the City's continued feasibility. As Leland clarifies:

> The [Moore] report demonstrates no understanding of what is driving CalPERS rate changes (which apply across the board statewide and are not unique to Stockton), and does not recognize that the LRFP builds in pension rate increases in excess of what CalPERS currently projects and that the City projects a balanced budget over a 30-year period, using revenue estimates that Moore believes are "conservative."

Leland DTD, ¶ 32.

Franklin further fails to acknowledge that while the CalPERS rates increase in the near-term, they taper off as later cost savings are realized and then drop dramatically over the long-term as unfunded liability is paid off, ultimately resulting in a normal cost rate with no unfunded liability. Leland DTD, ¶ 34. This cycle will not only ensure the long-term health of the pension system, but will also result in much lower pension costs in the future.

> [T]he fact that CalPERS rates are increasing is not cause to assume that these costs are any more unpredictable than the multitude of other expenditures and revenues about which the City must make

> assumptions. That is life in the budget world. The City makes assumptions about the future growth of all items in its LRFP. The issue of unpredictability is being addressed by CalPERS, which has become more transparent in their dealings with its member agencies . . . The recent rate smoothing, amortization and mortality improvements enacted by CalPERS, while significantly increasing rates over the next several years, are financially prudent changes that will improve the long-term funded status of the pension system, and reduce employer rates in the long run. Finally, <u>the increase in CalPERS costs is built into the LRFP and the forecast remains balanced</u>, with the City's reserve goal reached by 2034. This should be the ultimate test: even if certain costs increase, does the budget remain balanced? Stockton's LRFP meets that test.

Leland DTD, ¶ 35 (emphasis added). Thus, the LRFP already incorporates the City's CalPERS obligation, and provides an approach that absorbs higher costs in the near-term while enjoying greater savings in the long-term.

Despite the clear explanation of pension costs in the LRFP, Franklin does its best to make the City's pension obligations appear insurmountable. In order to do this, Franklin and Moore frequently resort to strained comparisons and misrepresentations. For instance, in his report, Moore compares the City's projections of its future contribution rates, prepared by Segal, with projections prepared by CalPERS, and suggests that the differences between the two projections are purely arbitrary. *See* Moore Report, at 20 (Table 8). In fact, the differences are due to better and updated assumptions used by Segal, including a decrease in the discount rate, fully generational mortality tables, a more accurate rate of return on market assets, adjustments to active demographics in the City's workforce, the impact of the PEPRA formula, and the addition of new members under the City's Marshall Plan. Direct Testimony Declaration of Kim Nicholl In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) [Dkt. No. 1379] ("Nicholl DTD"), Ex. A ("Nicholl Report"), at 8-9. Rather than acknowledge or discuss any of these assumptions, each of which has a sound actuarial basis, Franklin and Moore instead default to their standby argument that because a projection cannot be 100% accurate, it cannot be dependable. Franklin, for instance, quotes a portion of Kim Nicholl's careful explanation of various factors that may affect future contribution rates, Supp. Obj., at 21, but instead of examining any of these factors, Franklin simply jumps on the statement that they are "outside the City's control" as evidence that the Segal projections cannot possibly be counted on. Once again, Franklin fails to accept the fact that just because projections into the future can never be perfectly accurate does not mean that they cannot be reasonable estimates based on good data and reliable methodologies.

Similarly, in support of Franklin's contention that the City's pension obligations are "unsustainable," Moore compares the CalPERS employer rates for a group of "comparable" cities and proclaims that the City's forecasted Safety Plan contribution rates "are significantly above those of peer cities." Moore Report at 18-19, Ex. 12. Moore's analysis on this point is completely deficient, and seriously misrepresents the relative size of Stockton's post-employment benefits. *See* Goodrich DTD, ¶¶ 15-16; Nicholl Report, at 10. Despite claiming to be an expert in other post-employment benefits ("OPEB") matters and employee benefits, Moore fails to take into account that a city's CalPERS costs are only a portion of its post-employment compensation. Goodrich DTD, ¶ 15. This means that differences in compensation and benefit practices between cities may result in a given City's CalPERS costs making up a greater or lesser part of the City's *total* post-employment benefits. *Id.* Thus, in order to get an accurate comparison of post-employment benefits between cities, Moore should have considered numerous other factors, including each city's: (1) Social Security costs (while Stockton does not participate in Social Security, several of the listed "comparable" cities do); (2) Paid Employee's Member Contribution costs; (3) amounts paid into employees' deferred compensation programs in addition to CalPERS; (4) retiree medical benefits (which each of the 12 "comparable" cities provide, and which Stockton has eliminated); and (5) pension obligation bond debt payments. Goodrich DTD, ¶ 15 (discussing each factor). By ignoring all of these factors, Moore fails to consider the totality of each city's full post-employment obligations and "consequently reaches the erroneous conclusion that Stockton's costs are less sustainable than those for [the comparable cities]." *Id.*, ¶ 16.

Franklin and Moore also fail to acknowledge that while the estimated contributions have increased for all CalPERS employers, Stockton has reduced the impact of these increases through multiple measures. As the City's rebuttal expert, Kim Nicholl ("Nicholl"), explains:

> What Moore fails to acknowledge is that Stockton has reduced the impact of the estimated contribution increases covering new employees by adjusting future normal cost rates to account for the

> lower value, Tier 2/PEPRA arrangement these members will be covered under. The City has required safety employees to contribute 9% of payroll and miscellaneous employees to contribute 7% of payroll. Along with reduced compensation, such actions have resulted in lower pension costs for the City.

Nicholl Report, at 10; Direct Testimony Declaration of Kurt Wilson In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) ("Wilson DTD"), ¶ 16. In total, the City estimates that current employees' retirement packages have been reduced by 30-50% (depending on the employee). Deis DTD, ¶ 32. This reduction will increase to 50-70% for employees hired after January 1, 2013 under the State's retirement reform package. *Id.*

Thus, the City has already taken steps to lessen its pension obligations, and the Plan, as demonstrated by the LRFP, provides a path by which the City can absorb short-term increases in its pension obligations while maintaining its feasibility. Franklin's claim that the Plan cannot be feasible unless the City impairs CalPERS is therefore meritless.

B. <u>Franklin Offers No Alternative To The CalPERS System.</u>

Despite painting the City's pension obligations as uncontrollable, excessive, and unsustainable, Franklin fails to offer any workable and less costly alternative whatsoever. Instead, Franklin (and Moore) call for the impairment of the City's CalPERS pension obligations while ignoring the consequences that would ensue if Stockton were to terminate its relationship with CalPERS. For one, CalPERS would immediately assess a massive termination liability of approximately $1.6 billion. Nicholl Report, at 11. Moreover, CalPERS cannot legally use assets from another City to pay for benefits for Stockton employees. *Id.* Franklin appears to believe that if the City pays CalPERS only a portion of its pension costs, CalPERS will continue to provide full pension benefits to the City's employees, but this is clearly not the case.[12] An employer cannot deposit $80 in an employee's bank account and expect the bank to credit the employee $100. Likewise, the City cannot impair CalPERS without directly depriving its

[12] In support of its contention that the City can impair CalPERS, Franklin cites the decision of Judge Rhodes in *In re City of Detroit*, 504 B.R. 97 (Bankr. E.D. Mich 2013). However, the City of Detroit's pension program is fundamentally different than Stockton's. Whereas Stockton's pensions are administered through CalPERS, the City of Detroit's pensions were <u>self-funded</u> and <u>self-administered</u>. Thus, the clearest analog to Detroit's pension system is Stockton's retiree health benefits, which are also self-funded and self-administered, and which the City *has* impaired.

CalPERS beneficiaries. Impairing CalPERS would thus cause the immediate reduction of benefits to current and future retirees by the unpaid shortfall. Nicholl explains:

> The assets and liabilities for each agency covered by CalPERS are segregated. CalPERS therefore cannot use assets from another agency to pay the Stockton benefits. As a result, if Stockton does not pay the termination liability, then the benefits for its active employees and retired members would be reduced pro rata based upon the amount of the termination liability that is not paid. In this case, Stockton's members would have severely reduced pension benefits and active employees would receive no future accruals. New employees would not be covered under any pension plan. Under this scenario, Stockton would have difficulty retaining its existing employees and hiring new employees, as other cities in California cover their employees under pension plans.

Nicholl Report, at 11; *see also* Deis DTD, ¶ 14. This would leave many of the City's retirees living below the poverty line. Deis DTD, ¶ 14.

Further, without a competitive pension, the City will be unable to attract or retain qualified public servants. As Deis notes:

> Ninety-nine percent of government employees in California are in the CalPERS program or something very similar. Thus, CalPERS is the market standard. No viable, less-expensive alternative exists.

Deis DTD, ¶ 29. Stockton has already seen a significant departure of experienced personnel and, as Stockton's Police Chief and current and former City Managers have testified, if the City were to cut its pensions further, it is extremely likely that the City would lose even more police officers and other public workers. Direct Testimony Declaration of Eric Jones In Support Of Confirmation Of First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) ("Jones DTD"), ¶¶ 4-7; Wilson DTD, ¶ 15; Deis DTD, ¶ 23. The City is struggling with hiring and retention as it is, due to the substantial cuts to compensation and benefits that the City has already imposed, leading to the departure of a large number of public employees. Jones DTD, ¶¶ 4-7; Deis DTD, ¶ 30; Wilson DTD, ¶ 15. The City's understaffed police department has been particularly hard hit by officers leaving for other jobs. Of the 104 police officers that left the Stockton Police Department ("SPD") from January 2012 through March 25, 2014, 44 left for other police departments. Jones DTD, ¶ 7. This is particularly problematic because the City is losing *experienced* police officers; the average tenure of officers and sergeants has dropped from 14.22 years in 2009 to 9.34 years in 2014. *Id.* Under these conditions, the City cannot afford to further reduce its compensation package in a competitive marketplace, and thereby risk the further loss of experienced employees. Jones DTD, ¶¶ 4-7; Deis DTD, ¶ 30; Wilson DTD, ¶ 15. Police Chief Eric Jones, speaking from personal experience, explains:

> The Stockton Police Department is not competitive in the marketplace with other police departments and this is drastically affecting our retention and recruitment. . . . I continue to speak with exiting staff as well as various members of the department to keep a pulse on department morale. Most officers, as well as my managers and commanders, continue to tell me that if the Department's CalPERS contract is broken, they will depart to another agency. Others continue to say that they will leave the Department if any additional compensation or benefit cuts occur, or even if they fail to get any of their previous 20-30% cuts restored. The Department morale is fragile, and the continued instability is causing police officers to depart or apply to other law enforcement agencies. And all of this is happening at a time when Stockton most needs experienced, high-quality police officers.

Jones DTD, ¶ 7.

Rather than suggest even a single alternative by which the City might address or avoid such consequences, Franklin resorts to cliché, stating that "bankruptcy cases are the time to make hard choices." Supp. Obj., at 21.[13] Such platitudes merely attempt to conceal the fact that if the City is to remain viable, it has no other choice than to maintain its pension obligations. While Franklin calls for the impairment of the City's pension obligations, neither Franklin nor its expert explain how the City would deal with an overwhelming termination liability, how it would retain its employees while being the only major public employer without a pension plan, or what the legal basis or cost of any alternative plan would be.

VI. THE PLAN DOES NOT INFLATE THE RETIREE HEALTH BENEFIT CLAIMS

In the ten sections of the Bankruptcy Code that require present value discount, Congress instructs the court to "determine the value" as of a specific date. 11 U.S.C. §§ 1129(a)(7), (9),

[13] Franklin and Moore also raise, without explanation or elaboration, the perceived specter of the City of Vallejo. Supp. Obj., at 21; Moore Report, at 18. Franklin thus hopes to capitalize on rumor and speculation, rather than fact, in order to challenge the feasibility of the City's Plan. As explained in the Direct Testimony Declaration of Robert Deis, Franklin's comparison to Vallejo misses the mark. Deis DTD, ¶¶ 23, 27.

(15); 1129(b)(2); 1173(a)(2); 1225(a)(4), (5); 1325(a)(4), (5); 1328(b)(2). Use of the word "amount" indicates that 502(b) does not require a discount to present value. See 11 U.S.C. §502(b).

Recent case law has relied on this statutory interpretation to reject the cases upon which Franklin relies and hold that 502(b) does not require present value discount of all claims. *In re Oakwood Homes Corp.*, 449 F.3d 588, 597 (3d Cir. 2006) ("where the Bankruptcy Code intends a court to discount something to present value, the Code clearly uses the term 'value'"). In addition, it has been recently held that interpreting 502(b) to require present value discount of all claims renders the enumerated 502(b) exceptions superfluous. *In re Gretag Imaging*, 485 B.R. 39, 46 (Bankr. D. Mass. 2013) ("[i]f § 502(b) required all claims to be present-valued, there would be no need for [the] exceptions"). This additional aspect of the statute further supports the understanding that 502(b) does not require discount to present value of non-interest-bearing claims. *Id.* at 46.

Franklin eschews this case law and states that "overwhelming authority" requires present value discount of the Retiree Health Benefit Claims. However, much of the authority to which Franklin refers analyzes irrelevant 502 exceptions, is no longer good law, consists of cases in which the question of whether to discount to present value was never actually at issue, or relies on improper application of an irrelevant provision of the Bankruptcy Code.

Several of Franklin's authorities examine rejected employment contracts, which are specifically limited by section 502(b)(7). *Thompson v. Credit Union Fin. Group*, 453 B.R. 823 (W.D. Mich. 2011); *Pereira v. Nelson (In re Trace Int'l Holdings, Inc.)*, 284 B.R. 32 (Bankr. S.D.N.Y. 2002); *In re Thomson McKinnon Secs.*, 149 B.R. 61, 75 (Bankr. S.D.N.Y. (1992). Another examines a claim arising from the rejection of equipment leases, which are limited in section 502(g). *In re O.P.M. Leasing Servs., Inc.*, 79 B.R. 161, 161-67 (S.D.N.Y. 1987). Because the Retiree Health Benefit Claims arise under collective bargaining agreements, sections 502(b)(7) and 502(g) do not apply. At least one of Franklin's purported authorities, *In re Loewen Grp. Int'l*, is no longer good law. *Oakwood*, 449 F.3d at 601 ("[w]e decline to follow the approach of Loewen")).

Still other cases cited by Franklin do not actually issue a ruling as to whether section 502(b) requires a present value discount. In *Wisconsin Engine*, the court determined that a creditor had an allowed claim for the present value of the amount due on certain notes issued by the debtor, but the issue was whether the entire amount was due on the notes, not whether calculating that amount required present value discount. *In re Wisconsin Engine Co.*, 234 F. 281, 282, 284 (7th Cir. Wis. 1916). In *LTV Corp.*, the court held that bankruptcy law, rather than the Employee Retirement Income Security Act (ERISA), governed the discount rate for calculating allowed claims for terminated pension plans, but the issue considered was which statute's net present value calculation applied, not whether discount to present value was appropriate in the first instance. *LTV Corp. v. Pension Benefit Guar. Corp. (In re Chateaugay Corp.)*, 115 B.R. 760, 770 (Bankr. S.D.N.Y. 1990). In yet another case, the parties disagreed as to which ERISA provision provided the appropriate valuation method to calculate net present value, but the court never ruled on whether reduction to present value was appropriate. *Pension Benefit Guar. Corp. v. CF&I Fabricators (In re CF&I Fabricators)*, 150 F.3d 1293, 1300-1301 (10th Cir. Utah 1998).

Franklin cites other cases that mandate present value discount for all claims in order to uphold the alleged principle in section 1123(a)(4) that similarly situated creditors be treated equally. *In re CSC Indus.*, 232 F.3d 505, 509 (6th Cir. 2000); *CF&I Fabricators*, 150 F.3d at 1300. However, as recent case law has recognized, 1123(a)(4) "has nothing to do with allowance of claims." *Dugan v. Pension Ben Guar. Corp. (In re Rhodes, Inc.)*, 382 B.R. 550, 556 (Bankr. N.D. Ga. 2008). Instead, 1123(a)(4) serves "to protect the integrity of the voting process in a Chapter 11 case." *Id.* Other than improper application of section 1123(a)(4), these cases conduct little to no analysis regarding whether section 502(b) requires discounting to present value. *Oakwood*, 448 F.3d at 599, n. 13 ((citing *CSC*, *CF&I* and *In re O.P.M. Leasing Servs.*) ("several of these courts made sweeping statements declaring 11 U.S.C. § 502(b) to require discounting all claims to present value. However, these courts either conducted no inquiry at all into the issue, or concluded (contrary to our holding above) that § 502(b) was clear and unambiguous")).

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As the City has explained, by use of the word "amount" and enumeration of the 502(b) exceptions, the Bankruptcy Code mandates the conclusion that the Retiree Health Benefit Claims not be discounted to present value. 11 U.S.C. § 502(b). Notably, Franklin does not respond to this statutory analysis. Instead, Franklin urges the Court to follow the earlier cases, many of which are irrelevant and/or sparsely reasoned. More recent case law has departed from that earlier precedent in favor of well-reasoned, statutory construction. *See generally Oakwood Homes Corp.*, 449 F.3d 588; *Gretag Imaging*, 485 B.R. 39.[14]

VII. CONCLUSION

For the reasons set forth above, Franklin's objection to the Plan should be overruled, and the Plan should be confirmed.

Dated: April 28, 2014

Orrick, Herrington & Sutcliffe LLP

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[14] In its reply brief, Franklin also relies on the statements of its expert, Moore. Moore points out that the City did not discount to present value when calculating the City's retiree health care liability in the City's audited financial statements, and asserts that this is not "standard practice." Suppl. Obj. at 40, 41. Moore's testimony on this point is irrelevant. In calculating the amount of a claim in bankruptcy, it is the Bankruptcy Code, not the standards of the Governmental Accounting Board, which apply.