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State Pension Showdowns Call for New Federal Referee: Commentary

Commentary by Jonathan Henes | May 18, 2011 12:00AM ET

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(Bloomberg) -- For too long, states have been balancing their budgets through gimmicks and borrowing, moving liabilities from one pocket to another. And while these structural budget deficits and legerdemain are bad for states and their citizens, the biggest threat to everyone is unfunded pension and retiree obligations.

As we sit here today, the unfunded obligations of our public-pension funds and state-retirement systems are at unsustainable and dangerous levels. When the pension funds run out of money -- and some will -- either retirees will stop getting paid or taxpayers will foot the retirement bill, leaving less money for their own savings and spending.

Neither of these scenarios is fair, and so a process needs to be put in place to address the unfunded-liability problem -- the sooner the better.

Congress should consider enacting federal legislation to help states, public unions and public retirees achieve a real and fair restructuring of the public pension and retiree systems across the nation.

The precise amount of unfunded pension obligations is unknown because it is based on assumptions of the rate of return on the assets in the pension funds. Whatever assumptions are used, the unfunded amounts are enormous. Estimates range from the Pew Institute's \$1.26 trillion, assuming an 8 percent rate of return, to Northwestern University Professor Joshua Rauh's report of more than \$3 trillion, assuming a risk-free rate of return.

At an 8 percent rate of return, the pensions in seven states will run out of funds by the end of 2020 and the pensions in 20 states will run out of funds in 2025.

Limited Tools

Even if some states begin to take action against the enormity of this situation, their tools are limited and this results in perceived procedural unfairness. In Wisconsin, Governor Scott Walker and a requisite number of state legislators moved to severely curtail collective-bargaining rights of public employees. Before that law could be enacted, a lawsuit was filed and now the courts will decide whether it may go into effect.

In Michigan, an emergency-manager law was enacted, which empowers emergency financial managers to take over the financial affairs of local governments in a fiscal crisis. Among other things, emergency managers have the power to terminate existing contracts and collective bargaining agreements.

Two unions in Detroit filed a lawsuit in federal court arguing that the law is unconstitutional because it permits the state to impair contracts, which allegedly only the federal government can do under the Contracts Clause of the U.S. Constitution.

Pension Restructuring Board

Congress should step in to override the difficulties and potential legal constraints faced by states and local governments to restructure their public pension and retiree obligations in a fair and meaningful way.

I am proposing the creation of what I call the "National Pension Restructuring Board" under a new federal law, which could be called the "National Public Restructuring Act."

The purpose of the law would be to create a forum for a state to be able to modify its pension obligations if it can't reach a consensual agreement with its public unions. The forum would also allow the unions and other parties to be heard to assure a fair resolution.

The board might consist of five members appointed by the president and confirmed by the U.S. Senate. A state that can't reach a consensual agreement with its public unions could petition the board to make a determination on whether the states' proposed restructuring of the pension plan is fair and necessary.

Petition Requirements

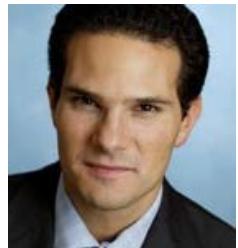
To have the petition considered, the state would need to demonstrate that it made a proposal to the union based on complete and reliable information. And it would have to show that it had provided for necessary modifications to the benefits of public employees and retirees to enable the state to balance its budget without gimmicks, to continue providing essential services to its citizens, and to operate under a five-year "business plan."

To assure arm's-length negotiations take place, state officials would need to show that they made themselves available to meet and actually met with the public union and retirees in good faith to seek a consensual arrangement, and that the public union and retirees refused to accept the modifications without good cause.

If the state made these showings, the pension restructuring board would hold a hearing to determine whether the modifications should be implemented. During this hearing, the board would also be permitted to attempt to mediate the issue and push both sides to a consensual resolution. If a consensual resolution still wasn't reached, the board would make a determination, and its decision could be appealed to a federal court.

Meeting Certain Standards

About the Author



Jonathan Henes is a partner in the Restructuring Group of the law firm of Kirkland & Ellis LLP in New York. He represents debtors, creditors' committees and distressed investors in acquisitions, restructurings and bankruptcy cases. The opinions expressed are his own.

The creation of the pension restructuring board will help both states and unions resolve the unfunded-pension issues. It will do so in a fair way since it would require both sides to negotiate and exchange information, and modifications to pension and other retiree obligations will only be permitted if the state could meet certain standards.

The law would provide rules and tools to achieve necessary modifications and, at the same time, the leverage both sides need to get to a consensual deal.

The concept of "unfunded" obligations needs to be removed from the public forum. The survival of certain of our cities and the ability for our cities and states to provide essential services to their citizens depends on a restructuring of public pension and other retiree obligations. The federal government needs to step in with targeted legislation.

(Jonathan Henes is a partner in the Restructuring Group of the law firm of Kirkland & Ellis LLP in New York. He represents debtors, creditors' committees and distressed investors in acquisitions, restructurings and bankruptcy cases. The opinions expressed are his own.)

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