

## **Understanding Puerto Rico's Pension Systems**

Puerto Rico's three pension systems (ERS, TRS, and JRS) (the "Systems") were dramatically changed following the enactment of Act 106 in August 2017.

- Prior to Act 106, the Systems each maintained both defined benefit plans (for which benefit payments were primarily funded by the Commonwealth and other agencies and municipalities that employed municipal workers) and hybrid plans (funded primarily by employer contributions). However, prior to Act 106, the Commonwealth's primary liability to the Systems was for its required annual contributions as an employer.
- Through Act 106 (enacted in August 2017), the Government transformed the Systems into a single pay-as-you-go system (whereby future benefit payments were guaranteed by Puerto Rico's general fund). Act 106 was enacted to address the immediate insolvency of the Systems and avoid extreme hardship and social disorder. The Government's exercise of its police powers in passing Act 106 represented a post-petition guaranty of retiree statutory obligations. As a result, the Oversight Board's contemplated plan of adjustment impermissibly seeks to modify these rights without the necessary legislative approval and required just compensation.
- Additionally, the treatment of pension obligations in the Detroit bankruptcy reflects the unique facts and circumstances of that case and should not control the treatment of Puerto Rico's pension Systems. As a starting point, the pension benefits at issue in the Detroit restructuring were contract claims under Michigan's Constitution and not property rights (vested pension benefits are clearly property rights under Puerto Rico law). The blind application of the Detroit bankruptcy as precedent also ignores the more recent case of the City of Stockton, California, where pensions remained unimpaired under the plan of adjustment in light of the value represented by other labor concessions negotiated by the City of Stockton.

## **Puerto Rico's Pension Systems Prior to Act 106**

ERS participants can be separated into two pools depending on date of entry into the system. ERS is a trust created by the Legislature of the Commonwealth in 1951 to provide pension and other benefits to retired employees of the Commonwealth, its public corporations, and municipalities of Puerto Rico. Employers participating in ERS include over 70 Commonwealth agencies, nearly 80 municipalities, and over 50 public corporations (collectively, the "Employers"). As of June 30, 2016, approximately 60% of the 178,741 ERS plan participants were Commonwealth employees.

- **ERS Pool 1: Pure Defined Benefits Plan** - Employees hired prior to January 1, 2000 are participants in defined benefit plans, with benefits accruing based on years of service. These plans have historically been funded exclusively by contributions from the Commonwealth and other Employers. However, active defined benefit plan participants started making plan contributions as of June 30, 2013, which are treated by ERS like contributions to the hybrid plans discussed below. Accrual of benefits under the defined benefit plans were frozen as of June 30, 2013.

- **ERS Pool 2: “Hybrid” Benefit Plan** - Employees hired after January 1, 2000 are participants in a “contributory hybrid plan,” which is funded exclusively by employee contributions (with no employer-funded benefits). Critically, while each participating employee receives a notional “credit” for each contribution held and invested by ERS, there is not a segregated account for each employee. Thus, the ERS “System 2000” plan is much more like a defined benefit plan than a defined contribution plan. The Governor of Puerto Rico will be filing legislation in June 2019 to appropriate approximately \$1.4 billion dollars to fund the System 2000 individual accounts.

TRS and JRS Participants can be separated into two pools depending on date of entry into the system. TRS is a statutory trust created in 1951 to provide pension and other benefits mainly to retired teachers of the Puerto Rico Department of Education, an agency of the Commonwealth, and the employees of the TRS. JRS is a statutory trust created in 1954 to provide pension and other benefits to retired judges of the Judiciary Branch of the Commonwealth. TRS and JRS are not debtors subject to a judicial restructuring under Title III of PROMESA (only ERS filed a petition under Title III).

- **TRS/JRS Pool 1: Defined Benefits Plan** - Employees hired prior to August 1, 2014 (TRS)/June 30, 2014 (JRS) are participants in a defined benefit plan, under which participants receive a percentage of their pre-retirement salary upon retirement. The plans were funded by both employee and Commonwealth contributions.
- **TRS/JRS Pool 2: “Hybrid” Benefit Plan** - Employees hired on or after August 1, 2014 (TRS)/July 1, 2014 (JRS) are participants in a “hybrid” plan, under which eligible retirees receive a percentage of preretirement salary plus an annuity from the employee’s contributions (with no employer funded benefits). Like the ERS hybrid plan, there is no segregated individual account for each employee (which is a defining feature of a true defined contribution plan).

Additionally, before commencement of the Title III cases, Puerto Rico had already implemented profound reforms when the Commonwealth legislated Act 3-2013. Unlike earlier statutes such as Act-1 and Act-305, which altered benefit accruals for prospective employees relative to benefits they would have received under previous plans, Act 3-2013 was a broad overhaul that froze defined benefit accruals as of June 30, 2013 for members in Act-447 and Act-1, eliminated employer provided benefits for Act-447 and Act-1 members, and eliminated or changed various other benefits for members in each of Act-447, Act-1 and Act-305. Below is a summary of the impact of Act 3-2013 on each of Act-447 members, Act-1 members and Act-305 members.

	<b>Act-447</b>	<b>Act-1</b>	<b>Act-305</b>
<b>System Type</b>	Converted to a member funded hybrid plan from a defined benefit		No Change
<b>Benefit Accruals</b>	No further defined benefit accruals. Future benefit accruals based on employee contributions plus return on investment		No Change

	Act-447	Act-1	Act-305
<b>Employer Contributions</b>	No further employer provided benefit		No Change
<b>Employee Contributions</b>	Increased from 8.275% to a minimum of 10% of compensation		
<b>Retirement Age<sup>1</sup></b>	From 58 to 68	From 65 to 68	From 60 to 68

The enactment of Act 3-2013 resulted in a decrease in the Actuarial Accrued Liability as of June 30, 2013 of \$3.27 billion, from \$24.28 billion to \$21.01 billion, or by **13.5%**. Additionally, the Unfunded Actuarial Accrued Liability as of June 30, 2013 decreased by \$3.27 billion, from \$23.54 billion to \$20.27 billion, or by **13.9%**.

*As a point of comparison, Detroit pension benefits were not reduced prior to Detroit’s bankruptcy filing. Accordingly, the Puerto Rico legislation summarized above must be accounted for when comparing the Puerto Rico and Detroit systems.*

### **Puerto Rico’s Pension Systems After Act 106**

On August 23, 2017, the Government enacted the Law to Guarantee the Payment of Our Pensioners and Establish a New Plan of Defined Contributions for Public Servants (Act 106), which transformed the Systems into a single pay-as-you-go system as contemplated in various iterations of the Fiscal Plan. Act 106 included a declaration that the Systems were in a state of “financial emergency” and cited sections of the Constitution of Puerto Rico vesting the Legislature with authority to pass laws “for the protection of the life, health and wellbeing of the People... when the health, public safety or essential government services are clearly in jeopardy.”

Under Section 2.4 of Act 106, the Government guaranteed payment of “Accumulated Pension” benefits under all of the previously described plans. Section 3 of Act 106 further contemplates that the guaranteed payments will be made out of (i) a newly created “Accumulated Pensions Payment Account” funded by the liquidation of ERS/JRS/TRS assets; (ii) a pay-go charge to be imposed on Commonwealth agencies, public corporations, municipal governments, and the judicial branch; (iii) budget assignments and special assignments to finance pension payment deficits; (iv) donations; and (v) other funds identified by Puerto Rico’s Legislative Assembly. The Government’s exercise of its police powers in passing Act 106 represented a post-petition guaranty of retiree statutory obligations. As a result, the Oversight Board’s contemplated plan of adjustment impermissibly seeks to modify these rights without necessary legislative approval and required just compensation.

Section 3.1 of Act 106 also creates a new “Defined Contribution Plan,” under which all participants in the Systems will make monthly contributions that will be placed in individual Defined Contribution Accounts. For each active plan participant, contributions to these accounts will supplement the “Accumulated Pension” benefits that existed prior to enactment of Act 106. The

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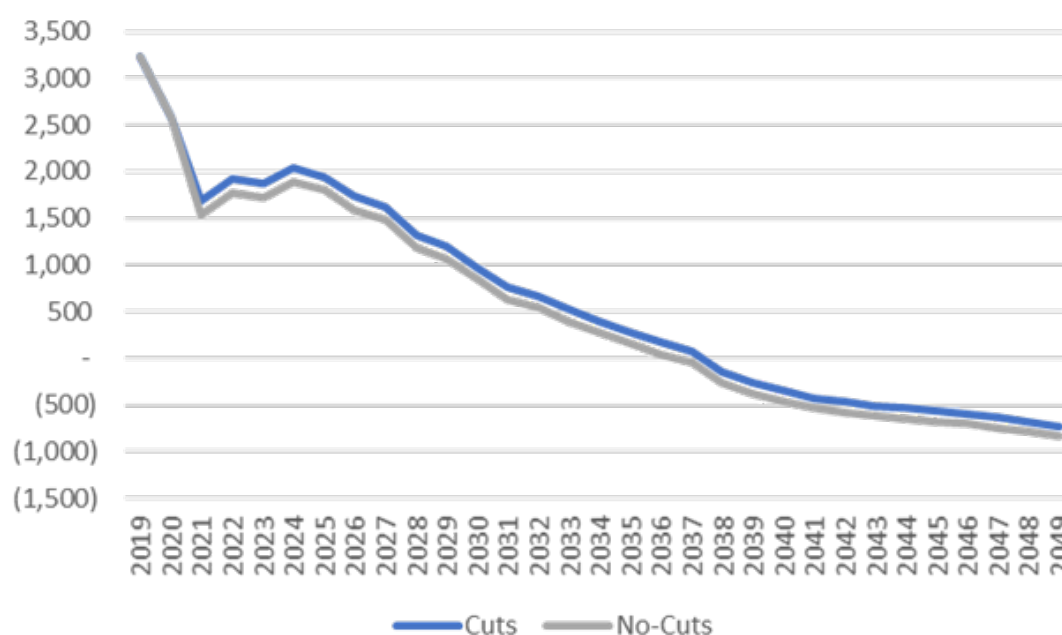
<sup>1</sup> With respect to the new retirement age of 68, members who, as of April 4, 2013, were close to attaining the required age under the laws in effect, may do so at a lesser age than 68 and will not be disproportionately affected by said modification.

employee contributions to the Defined Contribution Plan are deposited in a trust account held by the Trust Division of Banco Popular de Puerto Rico and separate from other funds of the Commonwealth of Puerto Rico. The Puerto Rico Retirement Board is in the process of contracting Alight Solutions, a provider of benefits administration and cloud-based HR and financial solutions, to provide administrative and recordkeeping services for the Defined Contribution Plan.

### **From a Fiscal Standpoint, Pension Cuts are not Needed**

The May 9th Certified Fiscal Plan has approximately \$100 billion of expense measures, \$4.2 billion (4.1%) of which are on account of pension cuts. Additionally, the pension cuts equate to ~\$125 million in the short term, which represents approximately 1.4% of the FY2019 General Fund budget. Simply put, pension cuts are neither needed from a fiscal standpoint for a plan of adjustment to be feasible nor the solution to Puerto Rico's financial situation. As can be seen in the chart below, the difference in the May 9, 2019 Certified Fiscal Plan cash flows including and excluding pension cuts is immaterial.

#### ***May 9<sup>th</sup> Certified Fiscal Plan Cash Flows – Including & Excluding Pension Cuts:***



Furthermore, cuts to pensions are not required by the bondholder constituency that just entered into a Plan Support Agreement with the Oversight Board. Indeed, Susheel Kirpalani, lead counsel to a subset of this bondholder group stated to Bloomberg News on June 17, 2019<sup>2</sup> that he believes keeping pensions whole is important for the economy of Puerto Rico going forward, pension cuts

<sup>2</sup> Please see minute 2:40 of the video found in the following link: <https://www.bloomberg.com/news/videos/2019-06-17/puerto-rico-unveils-35-billion-restructuring-plan-to-exit-bankruptcy-video> (last visited June 19, 2019).

are not required to facilitate the recently announced deal, and he looks forward to working with Gov. Rosselló as he has been able to do for years now.

### **Distinguishing Detroit and Next Steps**

Upon filing for chapter 9, the City of Detroit listed the General Retirement System of the City of Detroit (“GRS”) and the Police and Fire Retirement System of the City of Detroit (“PFRS”) as the City’s two largest general unsecured creditors.

Unlike the Puerto Rico Constitution, Article IX, Section 24 of Michigan Constitution states that “the accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.” Because the City of Detroit made clear that modification of its pension obligations was a key objective of its chapter 9 case, it was required to argue that the Bankruptcy Code preempted Section 24 of the Michigan constitution. Listing the full unfunded accrued actuarial liabilities under the GRS and PFRS plans as unsecured claims assisted Detroit in advancing that argument.

Ultimately, GRS and PFRS received multi-billion dollar allowed unsecured claims as part of the “Grand Bargain” at the heart of Detroit’s chapter 9 plan of adjustment. The plan separately classified GRS and PFRS claimants, who accepted reductions to or elimination of cost of living adjustment provisions (and a 4.5% reduction in monthly benefits under the GRS plans), in exchange for sizeable new contributions to the GRS and PFRS systems from the State of Michigan and other parties.

Furthermore, the bankruptcy court in the City of Stockton, California’s chapter 9 case rejected the legal argument that a plan of adjustment cannot be confirmed unless pensions are impaired. As reported by the Los Angeles Times<sup>3</sup>:

If Judge Christopher M. Klein had rejected Stockton’s plan and forced the city to slash its payments to CalPERS, it could have opened the door for other cities struggling with escalating pension costs to follow suit. Stockton officials had argued that they couldn’t afford to cut pensions or to create another retirement plan for city employees. They said employees would leave Stockton for other cities offering retirement benefits through CalPERS. CalPERS had said that if Stockton left the state retirement system, the city would immediately owe it \$1.6 billion -- far more than the city’s current bill to the pension plan... Klein said that workers had already taken hits in the bankruptcy. He said Stockton’s salaries and benefits for workers had been higher than those at other cities, but that workers had agreed after the bankruptcy filing to take big cuts, including eliminating the free medical care they received in retirement... Klein said that rejecting the plan after two years

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<sup>3</sup> “Judge approves Stockton bankruptcy plan; worker pensions safe,” *available at* <https://www.latimes.com/business/la-fi-stockton-pension-court-ruling-cuts-20141029-story.html> (last visited June 19, 2019).

in court and tens of millions of dollars in legal and other fees would have put the case back to square one.

Critically, while the City of Detroit elected to treat unfunded accrued actuarial liabilities under the GRS and PFRS plans as unsecured claims in order to effect pension modifications through a plan of adjustment, vested pension benefits are clearly property rights under Puerto Rico law and cannot be modified without just compensation. As a result, any desired modifications to the Puerto Rico pension Systems should be properly addressed through new legislation pursuant to the Commonwealth's continued exercise of its police powers. Enactment of such legislation would not subject the Commonwealth to prepetition liabilities, which must be classified and treated under a plan of adjustment.

### **Conclusion**

The Oversight Board should refrain from seeking to impair pensions in Puerto Rico's plan of adjustment and focus on garnering support from creditor constituencies and the Government of Puerto Rico as the safest course to confirm a plan of adjustment. Otherwise, the lack of legislative, executive and administrative support from the elected Government of Puerto Rico will make the plan unfeasible and thereby not subject to confirmation.