

## STRADLING YOCCA CARLSON &amp; RAUTH

## MEMORANDUM

**TO:** City of San José

**FROM:** Stradling Yocca Carlson & Rauth

**DATE:** April 15, 2021

**SUBJECT:** Pension Obligation Bonds

---

Pension obligation bonds (“POBs”) have become an increasingly common tool used by public agencies to reduce annual pension costs. POBs are issued to refund unfunded accrued liabilities (UAL) at a lower cost than the amortization rate of the UAL under a public agency’s pension plans. The City of San José (the “City”) has two pension plans, the Federated City Employees’ Retirement System (the “Federated Plan”) and the Police and Fire Department Retirement Plan (the “Police & Fire Plan” and together with the Federated Plan, the “Retirement Plans”). The Retirement Plans have been established by the voters of the City under the City Charter. City’s obligation to fund payments (including the UAL) to the Retirement Plans is an obligation imposed by Articles XV and XVA of the City’s Charter.

The City’s ability to issue bonds payable from General Fund revenues is limited by the State Constitution. Section 18(a) of Article XVI of the California Constitution (the “Constitutional Debt Limit”) says in pertinent part: “No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose...” Accordingly, the issuance of bonds secured by payments from the City’s General Fund generally would require a two-thirds vote of the electorate. However, certain judicially created exceptions to the Constitutional Debt Limit exist. These exceptions include: (i) the “lease exception” for contingent liabilities, (ii) the “special fund doctrine” for obligations secured by payments from a special/enterprise fund and (iii) an exception for certain obligations the City is legally obligated to make.

The legal basis to issue POBs is the City’s obligation to make the UAL and normal contributions to the City’s Retirement Plans imposed by law under the City’s Charter. POBs are issued pursuant to the provisions of the Articles 10 and 11 of Chapter 3 of Part 1 of Division 2 of Title 5 of the California Government Code (commencing with Section 53570) (the “Refunding Bond Law”). The Refunding Bond Law permits the City to issue refunding bonds to refund any existing “evidences of indebtedness” of the City. As an obligation imposed by law under the City Charter, the obligation to make the UAL payments and normal contributions constitutes an evidence of indebtedness for purposes of the Refunding Bond Law and can be refunded by POBS without voter approval

However, due to the lack of case law relating to POBs, Bond Counsel requires a judicial validation to obtain a Superior Court judgment that:

- the UAL is an obligation imposed by law under the City Charter
- the UAL can be refunded by POBs pursuant to the Refunding Bond Law
- the POBs when issued, will constitute the valid, legal and binding obligations of the City and are not subject to the Constitutional Debt Limit

The California Code of Civil Procedure Section 860, et. seq. allows public agencies to seek judicial validation of bonds and financial contracts to determine their validity. Bond Counsel will rely on the validation judgment in delivering its approving opinion relating to the validity of the POBS. A Bond Counsel approving opinion is required by the bond market for the City to successfully sell the POBS to investors.

Validation proceedings are “in rem” actions where the Court gains jurisdiction by requiring and ordering the publication of a summons to notify interested parties of the pendency of the City’s complaint to seek judicial validation. In addition to publishing the summons in a newspaper of general circulation in the City, the Courts typically require that the City mail the summons to each of the City’s unions as interested parties.

Steps related to the Judicial Validation and the City’s issuance of POBs include:

- Adoption by the City Council of a resolution authorizing the issuance of the POBS, the filing of the judicial validation action and approving for the POBs – the Trust Indenture and the Bond Purchase Agreement for the POBs in substantially final form and establishing a not to exceed par value and maximum interest rate
- Filing the validation complaint
- Seeking permission from the Court to publish the summons
- Publish the summons (once a week for three consecutive weeks, totaling 21 days)
- Response period to file an answer (10 days following completion of publication)
- Clerk’s entry of default judgment if no answer to the complaint is filed
- File points and authorities seeking entry of default judgment
- Hearing on judgment and Judge’s entry of default judgment
- Begin 30 day appeal period
- After the 30 day appeal period, return to Council for adoption of a resolution approving Preliminary Official Statement and confirm the size, structure and sale of the POBs
- Issue POBS

The appeal period described above commences on the date of the Judge’s entry of the default judgment. Any appeal would have to be filed with Court of Appeals and the basis for such appeal is generally limited to challenges to the Court’s jurisdiction, i.e. was the summons properly published.

Superior Courts have been impacted significantly by COVID-19. Completion of the judicial validation could take 4-7 months or even longer depending on Court impacts. If a party files an answer to the City's validation complaint, the City will need to make a business decision regarding whether or not it wants to proceed with litigating the validation action and incurring the additional litigation costs, which could be substantial. Alternatively, the City could dismiss the validation action. If the City decides to proceed forward with the validation complaint following an answer by a third party, this could result in substantial delays beyond the 4-7 month timeline described above.