
OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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McGuigan Settlement Modification

OVERVIEW

In September 2006, the City entered into a settlement of McGuigan v. City of San Diego (Settlement) related to the underfunding by the City of the pension system alleged by the McGuigan plaintiff class. Under the terms of Settlement, the City was obligated to pay \$173.0 million plus 7% simple interest on the amount outstanding to the pension system by June 8, 2011. The City has already paid a significant portion of the original Settlement amount (additional payments were made with tobacco settlement revenues, employee “pick-up” savings and City contributions made in addition to the pension ARC). The citywide amount currently outstanding, including interest, is approximately \$39.5 million if paid on the June 8, 2011 deadline.

Believing the June 2011 Settlement payment would create a budget hardship for the City in FY 2011, the Mayor proposed a short-term plan of finance in November 2009 to reduce the Settlement burden on the FY 2011 budget and spread the remaining Settlement payment over a five fiscal years beginning in FY 2011. As detailed in the staff report, the plan of finance has recently been modified to propose paying the Settlement over four fiscal years with the first annual payment being made early in FY 2012. Bank of America N.A. is the proposed lender.

In IBA Report [#09-90](#) (IBA Review of the Mayor's Proposed FY 2010/2011 Budget Solutions), we supported the proposed five-year financing plan citing a favorable estimated interest rate, negligible net financing costs and certainty that the Settlement obligation would be extinguished within five years. As the timing and structure of the financing plan has since been modified, this report comments on the revised plan of finance presented in the staff report, discusses important financing cost/timing considerations and actions necessary to facilitate the proposed Settlement modification.

FISCAL/POLICY DISCUSSION

Overview of Revised Plan of Finance

If paid on the June 8, 2011 deadline, the McGuigan Settlement results in a one-time citywide expense of approximately \$39.5 million (this includes principal and simple interest @ 7%). If the Settlement is pre-paid on June 30, 2010, this amount is reduced to approximately \$38.3 million. The Water and Wastewater funds are responsible for approximately \$4.4 million of the \$38.3 million prepayment. These departments have available funds and will save considerable interest expense by paying off their portion of the Settlement on June 30, 2010. The General Fund and other Non-General Funds would be required to cash fund approximately \$1.1 million of accrued interest on the Settlement amount through June 30, 2010. The General Fund portion of this expense (\$1 million of the \$1.1 million) was not contemplated in the adopted FY 10 budget and is now proposed to be funded from Citywide Program Expenditures budget. These costs were included in Financial Management's FY 2010 Mid-Year Budget Monitoring Report, presented to the Budget and Finance Committee on March 3, 2010. The resulting financing proposal involves financing the remaining Settlement balance of \$32.8 million over four years.

\$ 38.3M - Total Settlement Amount if Paid on June 30, 2010

(\$ 4.4M) - Total Settlement Pre-Payment by Water/Wastewater if Paid on June 30, 2010

(\$ 1.1M) - Total Accrued Interest on Settlement owed by GF/Non-GF on June 30, 2010

\$ 32.8M - Remaining Settlement Amount to be financed on June 30, 2010

The financing plan above is contrasted with the current Settlement obligation below:

\$ 39.5M - Total Settlement Amount if Paid on June 8, 2011 (Existing Obligation)

The remaining Settlement amount of \$32.8 million is proposed to be financed by Bank of America over four years. The resulting annual debt service payments would be the responsibility of the General Fund and other Non-General Funds, as the Water and Wastewater Utility funds will have completely paid off their share of the Settlement. Based on the most recent estimated interest rate for the proposed Settlement financing, the total annual debt service payment would be approximately \$9.0 million for four years beginning early in FY 2012. Of that amount, approximately \$7.9 million would be paid annually by the General Fund and \$1.1 million paid pro-rata by the other Non-General Funds.

Net Cost of Financing the Remaining Settlement Amount and the Importance of Timing

The IBA previously supported the earlier plan of finance (see IBA Report [#09-90](#)) in part because of favorable interest rates and negligible net financing costs. Barring unanticipated interest rate changes or delays in the proposed Settlement modification, these factors still hold true for the revised plan of finance. With respect to favorable interest rates, the most current estimated annual interest rate on the proposed Settlement financing is 3.95% (equal to the Bank of America's Taxable "Cost of Funds" Index plus 1.8%) which is considerably less than the 7.0% annual interest rate on the current Settlement agreement. Staff has estimated that the proposed Settlement financing will result in interest cost savings of approximately \$1.2 million.

Regarding negligible net financing costs, it is helpful to first compare total principal and interest costs provided by staff for each Settlement payment option as shown below. The difference (\$2.3 million) represents the additional cost of financing the Settlement over a longer period of time, from FY 2012 through FY 2015; however, an earlier infusion of the \$32.8 million Settlement amount into the City's retirement portfolio of assets on June 30, 2010 results in a significant reduction in the General Fund pension ARC payment in FY 2012.

\$ 41.8M - Total Settlement Principal & Interest Payments if Financed through FY 2015

\$ 39.5M - Total Settlement Principal & Interest Payments if Paid on June 8, 2011

(\$ 2.3M) - Additional Costs of financing the Settlement over a longer period of time.

\$ 3.4M - Estimated Offsetting Reduction in FY 2012 Pension ARC - primarily for the GF

\$ 1.1M - Net Financing Costs (no cost when future pension ARC reduction is considered)

It is important to note that the above referenced opportunity to reduce the City's FY 2012 pension ARC can only be realized if the proposed Settlement financing is executed as planned in FY 2010. If the proposed timeline to close the Settlement financing on June 30, 2010 slips by one day, an estimated \$3.4 million ARC expense reduction opportunity is lost.

When the IBA previously supported the earlier plan of finance, the Settlement financing was targeted for April 1, 2010 and the potential for unanticipated delays (attributable to necessary Court actions, plaintiff class delays, bank financing requirements, etc.) was a lesser concern. CFO staff has informed the IBA that they are planning for the Settlement financing to be executed on June 30, 2010 as proposed to secure the ARC expense reduction in FY 2012. Staff has further indicated that the McGuigan plaintiff class is interested in working with the City and the Court to facilitate the proposed Settlement modification.

Necessary Actions to Facilitate the Proposed Settlement Financing

The first action to advance the proposed Settlement financing requires the City Council to approve the Resolution for Settlement Modification. This Resolution provides rationale in support of a determination that paying the entire outstanding \$32.8 million Settlement in FY 2011 (on June 8, 2011) would result "in an unreasonable economic hardship to the City and its residents, businesses, visitors and special populations". The Superior Court will have to agree with this determination in authorizing the requested Settlement modification.

The Resolution also authorizes the Mayor or his designee to execute the Agreement Regarding Modification of Settlement Agreement and Agreement Regarding Purchase of McGuigan Judgment. The Agreement Regarding Modification of Settlement Agreement (between the City and the McGuigan plaintiff class) amends the existing Settlement Agreement to allow for the sale of the Judgment to a third party investor (proposed to be the Bank of America). The Agreement Regarding Purchase of McGuigan Judgment (between the City and the Bank of America) defines certain terms and conditions as preconditions to the Bank of America purchasing the Judgment from the McGuigan plaintiff class. Lastly, the Resolution determines that the Settlement modification as proposed will be beneficial to the City and SDCERS participants in that it will 1) result in an earlier payment of the remaining Settlement, 2) use four-year financing to reduce the unreasonable budget hardship in FY 2011 and 3) eliminate the need for the City to encumber real property as collateral to secure payment of the Settlement (once Bank of America pays SDCERS the remaining \$32.8 million Settlement on June 30, 2010, SDCERS will convey deeds of trust for property they hold as collateral back to the City).

Once the City Council approves the Resolution, the Court will be asked to approve the Settlement modification (tentatively planned for May 14, 2010). The McGuigan plaintiff class would then be sent a notice of a “Fairness Hearing” (tentatively planned for June 25, 2010) where interested parties could express concerns, if any, related to the Settlement modification. After the conclusion of the Fairness Hearing, the proposed Settlement modification would become final and the Judgment would be assigned to Bank of America. The City and the Bank would then execute the proposed four-year financing and Bank of America would pay the \$32.8 million Settlement to SDCERS on June 30, 2010.

CONCLUSION

Given favorable estimated interest rates, negligible net financing costs, and certainty that the Settlement obligation will be extinguished within four years, the IBA recommends the City Council support the requested McGuigan Settlement modification by adopting the proposed Resolution. It will be important for CFO and City Attorney staff to work expeditiously to process all necessary financing and court actions to consummate the financing by June 30, 2010. The financing and Settlement payment to SDCERS must be finalized by this date in order to reduce the City's pension ARC by over \$3 million in FY 2012. **As adoption of the Resolution will be the only action required of the City Council, the IBA further recommends that the CFO be asked to apprise the City Council of significant Settlement financing developments as they occur (completed court actions, Fairness Hearing, Judgment assignment, final financing terms and/or any other significant/unanticipated developments).**

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