Public Pension Reform: What Are The Options?

by John D. Wahlin



As states and local public agencies wrestle with today's economic challenges, public employee retirement benefits have become a prime target for cost savings. Reducing costs by cutting benefits, however, is in most states a challenging proposition. Changes that diminish vested pension rights of public employees violate the constitutional prohibition, both federal and state, against impairment of contracts. However, the prohibition does not immunize employees against all changes, and modification may be made in vested pension rights of active employees if reasonable and related to the integrity or successful operation of the pension system, and if offset by comparable new advantages to employees. In addition, conditions of employment which may affect an employee's pension are not vested rights and are subject to modification.

I. The Basic Rule of Public Employee Vested Pension Rights

State and local pension plans are largely exempt from ERISA. As a result state and federal courts look to the federal Constitution and state law in determining the extent to which public pension benefits can be cut back. While options for change vary from state to state, there are primarily two approaches which are followed throughout the country. Each is based on the theory that pension benefits are a vested right of the public employee which cannot be abrogated.

A. Vested right only to accrued benefits. Several states follow the same rule as applies under ERISA to private employer plans. Public employees who otherwise satisfy eligibility and service requirements of the plan cannot forfeit any benefit he or she has accrued. For example, if the plan provides that the pension is 2% of salary for each year of service, an employee with 10 years of service would have accrued a pension of 20% of salary. However, he or she would not have a vested right at that point in time to a higher pension based on working additional years.

As a result of this limitation as to future service, a public employer (like private employers) can cut back or even eliminate future benefit accruals. Where benefits are not subject to collective bargaining the employer may have significant leeway in reducing its future costs. If pension benefits are subject to collective bargaining, the agreement controls but pension benefits can be prospectively modified and reduced in the bargaining process.

B. Constitutional right to a pension which vests upon employment. Several states such as California apply a rule which significantly limits options to cut back or otherwise modify pension benefits. That principle is that a public employee, upon rendering services under a pension statute, secures vested pension rights, as set forth in *Kern v. Long Beach.*[1] This right is based on the contract clauses of the California and U.S. Constitutions, which prohibit impairment of contract rights. The contract right, however, is to the expectancy of the prescribed pension and is subject to the employee satisfying service and vesting conditions under the plan. So, the employee's vested right is limited in two respects. First, it is subject to loss based on conditions of employment, such as a lawful termination of employment before completion of the period of service designated in the pension plan, or the occurrence of conditions expressly contained in the pension statutes at the time of the employee's employment or subsequently added.[2] Second, although the right bars the application of legislation abolishing the pension,[3] pension rights are subject to reasonable modification, provided that any disadvantage to employees is offset by a comparable new advantage.[4]

The vested pension right under the federal Contract Clause has also been recognized in Federal Courts. In *San Diego Police Officers' Association v. San Diego City Employees' Retirement*

System[5] and *Nevada Employees Association v. Keating*[6] the Ninth Circuit acknowledged that the federal Contracts Clause protects contractual rights created under state law, including pension rights. In addition, other states such as New York have invoked the contract clause of the state constitution in holding that pension rights are fixed upon entry into the pension system.[7]

The California rule regarding vested rights which accrue upon the rendition of service under a pension statute would appear to apply regardless of whether the statute requires employee contributions to the pension fund. Thus, the rule has been held applicable where it appeared that the employee's compulsory contributions to the pension plan were not required until some time subsequent to the date of employment.[8]

Finally, it is important to note that only current employees and retirees are vested; subject to any limitations under the pension system itself, pension benefits can be modified or even eliminated for future hires.

1. Reasonable Modification.

With respect to the reasonable modification rule, the *Kern* court held that an employee's vested rights are not rigidly fixed by the specific terms of the legislation in effect during any particular period in which the employee serves. Instead, the statutory language is subject to the implied qualification that the governing body may make modifications and changes in the system; the employee, the court held, does not have a right to any fixed or definite benefits, but only to a substantial or reasonable pension.[9] Whether a particular modification of a pension plan is reasonable is for the courts to determine. To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which disadvantage employees must be accompanied by comparable new advantages.[10]

In *Allen v. Long Beach*, the permissible bounds of modification were exceeded by a municipal charter provision altering the pension rights of policemen and firemen. The provision increased the amount of each employee's contribution to the retirement system, and changed the method of computing benefits payable to retiring employees. It also required employees absent by reason of military service to pay into the retirement fund, upon reinstatement, an amount equal to that which would have been deducted from their salaries had they not been absent.[11]

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Other recent cases, although not quite on point, reaffirm the holdings of older cases. For example, an attempt by the state to modify judicial pensions by reducing salaries of active judges to which pensions of retired judges were tied was improper, as the former judges had retired with the expectation of unlimited cost of living increases and were considered to have a vested right to that benefit.[12] Similarly, a California constitutional amendment added by initiative in a general election which placed limits on the number of terms elected officials could serve, providing that no pension or retirement benefits could accrue for service after the effective date of the amendment, was an unconstitutional infringement of the vested pension rights of incumbent legislators, where all incumbent legislators had acquired vested rights to earn additional pension benefits through continued service under the pension system in effect at the time they commenced service.[13] However, the amendment could be applied to non-incumbent legislators first assuming office after the effective date, since they acquired no vested or protectable right to continuation of the pension system prior to their employment. [14]

For an example of a modification held to be reasonable where it was accompanied by a comparable advantage to the employee see *City of Downey v. Board of Administration.* There, statutory amendments to a public employee's vested contractual pension rights were not unconstitutional because, although the amendments increased the rate of contribution by employees, that increase was offset by an increase in the amount of retirement allowance; in addition, the amendments reduced the mandatory retirement age from 70 to 67, and entitled employees' spouses to receive either monthly allowances or lump sum amounts.[15]

The rule was recently reaffirmed in *Maffei v. Sacramento County Employees' Retirement System*, where the court held that an employee's vested contractual pension rights may be modified prior to retirement for the purpose of keeping the pension system flexible to permit adjustments in accord with changing conditions and at the same time to maintain the integrity of the system.[16] *Continued on page 12*

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There is no clear guidance as to what constitutes a reasonable plan modification. Rather, courts reiterate that the determination depends on individual circumstances. Some cases do provide hints as to what courts are looking for and what arguments they discard as insufficient. For example, in *Abbott v. City of San Diego*, the court easily disposed of the City's argument that the substitution of a fixed for a fluctuating pension was reasonable in light of a continual expansion of benefits under the City's pension plan prior to the proposed amendment.[17] The court stated that those prior benefits had no bearing on the reasonableness of the new detriment imposed because they become a part of the vested rights of the employees when conferred.[18] The City went on to argue that the change was necessary to make its pension program economically sound. The court rejected this argument on the basis that the City made "no showing . . . that the amendments . . . bear any material relation to the integrity or successful operation or to the preservation or protection of the *pension program applicable to the employees*" (italics in original).[19] In fact, the court noted that the facts demonstrated the contrary since the financial integrity of the pension system prior to the proposed modification was guaranteed by the City, and adequately secured by its taxing power.[20]

At least one California court of appeals decision found that a pension system in which benefits are payable only to the extent funded by specified contributions might be able to reduce benefits or increase employee contributions in order to save the system from bankruptcy.[21] However, in the absence of a clear and unequivocal declaration in the pension provisions that benefits are payable only to the extent of available funds from specified contributions, the liability to pay promised pension benefits is a general obligation of the governmental entity.[22] And as mentioned earlier, suggestions of fiscal emergency have been rejected on the particular facts of several cases.[23]

2. Comparable new advantages.

Until the California Supreme Court decided *Allen*, the prevailing rule had been simply that modifications be reasonable.

Several recent cases hold that a modification of a retirement plan pursuant to a reservation of the power to do so does not violate federal or state Constitutions.

In 1955 *Allen* required not only that modifications be reasonable but that they be accompanied by a comparable advantage.[24] Courts have held that the analysis of disadvantages and compensating advantages must focus on the particular employee.[25] Further, courts have held that the offsetting improvement must also "relate generally to the benefit that has been diminished."[26] For example, in *Frank* the PERS Board of Administration asserted that due to a change in classification the employee was not entitled to industrial disability retirement benefits but rather ordinary disability retirement benefits. To justify the modification, the Board pointed to purported advantages including a reduction in the contribution rate and an increase in the employee's potential service retirement allowance by 20%.[27] The court rejected this assertion, finding that removing the employee's right to a substantial disability pension "[could not] constitutionally be compensated by new benefits which relate entirely to service retirement."[28] Further, the court found, "[e]ven if the monetary value of the new service retirement benefits far exceeds the amount by which plaintiff's disability retirement is diminished, the gain cannot equalize the loss, for the two retirement pensions are actually different benefits. In fact, they are mutually exclusive."[29]

The requirement that modifications disadvantageous to the employee be offset by advantages was applied in *Abbott v. City of Los Angeles*, where it was held that the substitution of fixed for fluctuating pension benefits was not permissible where not accompanied by commensurate benefits.[30] And in *Cochran v. City of Long Beach*, a modification of a city charter provision to fix the pension of retired policemen at a definite amount, rather than an amount fluctuating according to the rate of pay of persons holding the rank held by individual policemen at the time of their retirement, was held invalid as applied to a policeman whose employment antedated the modification, on the ground that the modification worked a detriment unaccompanied by any advantage.[31]

Similarly, in *Betts v. Board of Administration*, an amendment fixing pension benefits for elective state officers at the percentage of highest compensation received while in office, rather than being based on the highest salary authorized for the office during the officer's term, could not be constitutionally applied to a former state treasurer, because it deprived the pensioner of vested rights and provided no comparable new advantages.[32]

3. Modification pursuant to reserved powers.

Several recent cases hold that a modification of a retirement plan pursuant to a reservation of the power to do so does not violate federal or state Constitutions.[33] The principal case adopting this approach distinguishes the controlling line of cases discussed above, principally *Kern, Allen, Abbott* and *Betts*, based on the nature of the contractual rights which became vested in the employees upon their acceptance of employment.[34] In the controlling cases, vested contractual rights of employees were modified by amendment. In contrast, in *International Association of Firefighters*, "no modification was made in the retirement system; instead the revision… [was] made pursuant to the charter and ordinances which delineate City's retirement system and prescribe the employees' vested rights"[35] (italics in original). The revision at issue in *International Association of Firefighters* involved a change in the contribution rate which under the terms of the pension statute (City Charter) was actuarially-based rather than fixed. As such, the court concluded, "change in contribution is implicit in the operation of the City's system and is expressly authorized by that system and

no vested right is impaired by effecting such change."[36]

4. Repeal followed by substitution. Although courts have held that abolishing a public employee's rights to a statutory pension is expressly prohibited, the *Kern* court softened this stance, stating that an employee may not be deprived of all pension benefits by a repeal of the statute without the enactment of a substitute.[37] The idea that an existing pension can be repealed so long as a substitute is enacted in its place is further supported by the court's affirmation in *Pennie v. Reis*.[38] In *Pennie*, a death benefit payable to legal representatives was eliminated by the implied repeal of a pension statute, but the repealing statute substituted a more comprehensive pension system which included a death benefit payable to certain dependents. The *Kern* court observed that the "practical result was a modification which gave the employees more pension benefits than they had before."[39]

5. Conditions of employment. While recognizing vested pension rights, courts have also consistently distinguished that right from the public employer's right to modify conditions of employment.[40] For example, the *Kern* court indicates that a lawful termination of employment before completion of the period of service designated in the pension plan results in a forfeiture of the prospective pension.[41] Likewise, in the *San Diego*[42] case the federal court determined that a reduction in salary tied to benefit under the City's DROP pension program was permissible because no employee had a guarantee of a certain salary. Similarly, where a state employee was compulsorily retired pursuant to a statutory change at an earlier retirement age than was provided when he entered public employment and had joined the public employees' retirement system, the court held that the diminution of in his monthly pension due to reduced years of service was the result of a change in his employment terms and not from impairment of vested rights.[43]

A reduction in the amount of the designated employee contribution under the pension plan paid by the employer has also been permitted under the same theory. It is a common practice with public agencies to "pick-up" all or a portion of the designated employee contribution. Under the Internal Revenue Code, amounts paid by the agency on behalf of employees is treated for tax purposes as an employer contribution (and not therefore currently taxable). But the courts have been careful to distinguish between the tax treatment and the character of the payment as an employee contribution. The Ninth Circuit explains that a reduction in the pick-up is a change in compensation only; the designated employee contribution amount, which is a protected contractual right, is not changed.[44]

II. Impact of Collective Bargaining.

There is no case law, at least in California, holding that vested pension rights can be cut back in the collective bargaining process, even though benefit enhancements can be part of the bargaining process. The rationale is that an individual employee's contractual pension rights cannot be impaired except by the agreement of the individual employee.

III. What are the Options?

As the cases reflect, subtle distinctions can make the difference between a "change" abrogating a vested right or simply being a plan feature subject to modification under the terms of the plan. If a vested right is at issue, changing the benefit for current employees is problematic; demonstrating that a "comparable new advantage" is being provided appears to be a difficult proposition. Further, most pension systems do not by their terms reserve the right to reduce benefits. On the other hand, the courts are generally prepared to allow a modification which can be characterized as a condition of employment, including compensation, relying on the underlying assumption that an employee's salary can always be changed or his or her employment terminated. What can be gleaned from the California cases and other states which rely on the vested right principle, are the following:

A. Prospective Changes for New Hires. Future hires enter employment with no vested pension right and public agencies are typically addressing reform (and cost-saving) through plan changes that reduce benefits for future hires and cost. The simplest change is a reduction in the benefit formula but many agencies are also going to a "hybrid" approach under which a defined contribution 401(k) type plan is adopted to complement the modified defined benefit plan. Since public agencies cannot establish a 401(k) plan, the model which comes closest is a defined contribution plan which provides a matching contribution to the employee deferrals under a 457 deferred compensation plan. The defined contribution plan can also include a separate employer level contribution beyond the match.

B. Changes Applicable to Current Employees. Changes that apply only to future hires unfortunately do not bring significant cost savings over the short run and agencies therefore need to look for cost savings related to current employees that do not run afoul of the vested pension right. As previously noted, showing that a change is both reasonable and offsets any disadvantage by a comparable advantage is a high standard to meet when cost containment is the underlying goal. A further challenge is that a substantial percentage of the employees will be in bargaining units and any proposed changes must survive that process. Whether bargaining is involved or not, the following actions appear to have a reasonable or high chance of withstanding the argument that a vested right is involved:

1. Rate of Pay; Plan Definition of Pay. If an employee's compensation is reduced, his or her pension is likely to be reduced along with its cost. In today's environment, it is not that rare to see employee groups agree to actual pay rate reduction, which involves no direct change to the pension plan.

At a different level, it may be possible to modify the definition of salary/wages used to calculate the pension. For example, using average pay over the final five years will result in a lower pension that using the highest year alone. This change could draw an employee objection that it impairs a contractual right; the counter argument is that if compensation can actually be reduced (and therefore the pension), simply redefining compensation (within reasonable limits) to result in a lower amount for plan purposes does not infringe on the right to a basic pension. In fact the

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employee is better off than he or she would be if compensation were actually reduced.

2. Reduction in Employer Contribution. There are two possibilities relating to the amount of employer contribution. The first, which has been discussed, is a reduction the amount of the employer pick-up of employee contributions. This appears to be very low risk based on the case law and also the fact that it is often a subject of bargaining agreements as a compensation item. Certainly in California this has become a very popular source of cost cutting.

The second option is to reach agreement with the employees, both those in bargaining units and those that are not, to have them contribute a percentage of compensation to defray the employer's funding liability. This option is offered under the California system, CalPERS, but is not necessarily going to be an option in other systems. The tax treatment of the payments (i.e. whether it is a pre-tax contribution to the employee as if a pick-up) is also not resolved, although the IRS apparently is aware of the issue.

3. Elimination of Airtime. Many public plans allow employees to enhance their retirement benefit through the purchase of additional years of credit for years they didn't work, usually up to five. While the cost is intended to be borne entirely by the employee, it is an actuarial calculation that can result in the cost being understated (for example, investment return is lower than projected). Since the airtime is not based on actual service, eliminating it arguably does not affect the plan benefit and would not appear to infringe on the vested right.

4. Changes in Retirement Age. A reduction in the mandatory retirement age has been upheld, as one's retirement date is considered a condition of employment—i.e. there is no guarantee of employment to a certain date. However, the type of change which would have the greatest cost reduction is an increase in the normal retirement age without actuarial adjustment. For example, many public plans allow retirement at age 50 based on the plan formula. Changing that point to age 55 likely results in a lower cost because the pay-out period is shorter. It is true that the employee would accrue additional benefits in those years, but the value of that benefit typically is lower than the benefit starting at age 55. The corollary to this change is that there would be an actuarial adjustment to the benefit if the employee chose to retire at age 50 and commence receiving the benefit before age 55; that change clearly would reduce costs.

Raising the retirement age is likely to be challenged as eliminating a vested right, depending on the benefit structure of the particular plan. However, a reasonable argument can be made that the retirement age is a condition of employment subject to change by the employer. This is likely to be a key issue in legislative reforms and an aggressive approach by public employers is anticipated.

5. Elimination of Supplemental Pension. The limits on retirement benefits under Section 415 of the Internal Revenue Code apply to public employer plans. Under current rules the maximum annual pension is $195,000, commencing at age 62. If retirement is prior to age 62, the maximum benefit is actuarially adjusted to a pension that is lower than $195,000. In order to preserve a pension under a public plan which would exceed the federal maximum, many public agencies provide a supplemental benefit under a separate "governmental excess benefit arrangement."

The adverse publicity surrounding substantial pensions for management employees of public agencies will no doubt draw attention to these supplemental arrangements in proposed reforms. While these plans preserve the pension which the employee would receive in the absence of the 415 limit, they are not a part of the basic pension and on that basis it can be argued that it is not a vested pension right—only the basic plan in which all employees participate provides the vested benefit. If that position can be successfully taken, it would still need to be determined what benefit under the supplemental plan had accrued as of the date the benefit was eliminated.

Aside from the question of whether this supplemental pension can be cut back for current employees, this idea would have traction with respect to future hires in negotiating employment terms for city managers and other management employees.

Conclusion

As municipalities and other public agencies address the escalating cost of pension benefits and seek to implement reforms, there clearly are options which can reduce costs on an immediate basis without impairing contract rights of public employees. Longer term solutions, however, may involve reform legislation at the state legislature level as many pension systems are creatures of state statutes. Ultimately, lower benefits under defined benefit plans along with higher contributions from employees will need to be implemented. The model for the future is a hybrid arrangement in which a defined contribution 401(k) type arrangement supplements a leaner defined benefit plan.

Notes

1. *Allen v. Long Beach*, 45 Cal. 2d 128 (1955); *Packer v. Board of Retirement*, 35 Cal. 2d 212 (1950); *Kern v. Long Beach*, 29 Cal. 2d 848 (1947) (indicating that an employee's right in the pension vested at the time a contractual duty to make salary payments to him or her arises, since a part of the compensation which the employee has at that time earned consists of pension rights); *Gibson v. San Diego*, 25 Cal. 2d 930 (1945); *Dryden v. Board of Pension Commissioners*, 6 Cal. 2d 575 (1936).
2. *Malone v. Los Angeles,* 126 Cal. App. 2d 447 (1954); *Ross v. Board of Retirement*, 92 Cal. App. 2d 188 (1949); *Hunter v. Sparling*, 87 Cal. App. 2d 711 (1948); *MacIntyre v. Retirement Board*, 42 Cal. App. 2d 734 (1941).
3. *Carey v. Retirement Board of San Francisco*, 131 Cal. App. 2d 739 (1955); *Hunter*, *supra* note 2; *Kern, supra* note 1.
4. *Kern*, *supra* note 1; *Allen*, *supra* note 1, at 131.
5. *San Diego Police Officers Association v. San Diego City Employees' Retirement System*, 568 F.3d 725 (9th Cir. 2009).
6. *Nevada Employees' Association v. Keating*, 903 F.2d 1223 (9th Cir. 1990).
7. *Birnbaum v. New York State Teachers Retirement System*, 5 N.Y.2d 1 (1958).
8. *Kern v Long Beach*, 29 Cal2d 848 (1947).
9. *Id.* To the same effect as the *Kern* de-

cision see *Allen*, *supra* note 1; *Wallace v. Fresno*, 42 Cal. 2d 180 (1954); *Packer*, *supra* note 1; *Brooks v. Pension Board*, 30 Cal. App. 2d 118 (1938) (indicating that, prior to happening of last contingency, amount of pension may be increased or decreased, as circumstances demand).
10. *Allen, supra* note 1.
11. *Id.*
12. *Olson v. Cory*, 27 Cal. 2d 352 (1980).
13. *Legislature v. Eu*, 54 Cal. 32 492 (1991).
14. *Id.*
15. *City of Downey v. Board of Administration*, 47 Cal. App. 3d 621 (1975).
16. *Maffei v. Sacramento County Employees' Retirement System*, 127 Cal. Rptr. 2d 279 (App. 3d Dist. 2002).
17. *Abbott v. City of San Diego*, 165 Cal. App. 2d 511, 518 (1958).
18. *Id.*
19. *Id.* at 520.
20. *Id.*
21. *Houghton v. City of Long Beach*, 164 Cal. App. 2d 298, 304, 306 (1958).
22. *Bellus v. City of Eureka*, 69 Cal. 2d 336, 348-352 (1968); *Carman v. Alvord*, 31 Cal. 3d 318, 332-333 (1982).
23. *Allen*, *supra* note 1, at 133; *Abbott v. City of Los Angeles*, 50 Cal. 2d 438, 455 (1958); *Wisley v. City of San Diego*, 188 Cal. App. 2d 482, 487 (1961); *Frank v. Board of Administration*, 56 Cal. App. 3d 236, 246 (1976).
24. *Allen*, *supra* note 1, at 131.
25. *Abbott v. City of Los Angeles*, *supra* note 22, at 449-453; *Frank*, *supra* note 23, at 245; *Abbott v. City of San Diego*, *supra* note 17, at 518.
26. *Frank*, *supra* note 23, at 244; see also *Stork v. State of California*, 62 Cal. App. 3d 465, 471 (1976).
27. *Frank*, *supra* note 23, at 244.
28. *Id.*
29. *Id.*
30. *See generally*, *Abbott v. City of Los Angeles*, *supra* note 22; *and Abbott v. City of San Diego*, *supra* note 17.
31. *Cochran v. City of Long Beach*, 293 P.2d 839 (1956).
32. *Betts. v. Board of Administration*, 21 Cal. 3d 859 (1978).
33. *See Int'l Assoc. of Firefighters, Local 145 v. City of San Diego*, 34 Cal. 3d 292 (1983); *Walsh v. Board of Administration of the Public Employees' Retirement System*, 4 Cal. App. 4th 682, 700 (1992) (affirming the holding in *Int'l Assoc. of Firefighters*); *United Firefighters of Los Angeles City v. City of Los Angeles*, 210 Cal. App. 3d 1095, 1105 (1989) (same); *Pasadena Police Officers Assoc. v. City of Pasadena*, 147 Cal. App. 3d 695, 703 (1983); *see also* Opinion of the Attorney General, 80 Cal. Op. Att'y Gen. 119, pg. 9 (1987).
34. *Int'l Assoc. of Firefighters*, *supra* note 39, at 302.
35. *Id.*
36. *Id.* at 303.
37. *Kern*, *supra* note 1, at 853.
38. *Pennie v. Reis*, 80 Cal. 266 (1889).
39. *Kern*, *supra* note 1, at 854.
40. *Vielehr v. California*, 104 Cal. App. 3d 392 (1980).
41. *Kern*, *supra* note 1, at 853.
42. *San Diego*, *supra*, note 5.
43. *Miller v. State of California*, 18 Cal. 3d. 859 (1977).
44. *San Diego*, *supra* note 5. ML

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transactions or securities held at different times over different periods of time. In sum, calculating a loss on one transaction for one plaintiff will be complex. Calculating a loss for a class on a universe of transactions will be even more challenging.

Due to the difficulties associated with antitrust class actions, LIBOR-related litigation is likely to grow as institutional investors with potentially large claims decide to opt out of the classes and file individual claims. Those types of lawsuits may have a greater chance of success as compared to the class action antitrust litigation because it is easier to calculate damages arising from one or two large transactions for a single plaintiff, such as an interest rate swap. Institutional investors who choose to opt out of the class actions and bring individual claims may also find it easier to allege claims for fraud and unfair and deceptive trade practices based on representations that the defendant banks may have made to the plaintiff as its client.

Given the size of the market for investments tied to LIBOR, the LIBOR scandal could prove to be the most significant type of litigation arising out of the financial crisis. Many investors, however, may not even recognize the damages they have suffered as a result.

II. The Municipal Bond Big-Rigging Scandal

Municipalities and other local governmental entities may have also lost money as a result of an alleged bid-rigging scandal in the municipal bond market. Municipalities often raise capital to finance long-term projects through the issuance of tax-exempt bonds. When a city issues these tax-exempt bonds, the bond proceeds are typically invested in various investment products sold by major financial institutions until the bond proceeds are needed to complete the project. These products, which are referred to generally as municipal derivatives, are tailored to meet the bond issuers' specific collateral and spend-down needs, and include products such as guaranteed investment agreements (GICs), repurchase agreements (repos), and forward purchase agreements (FPAs). To ensure bond proceeds are invested at fair market value, most issuers submit their bond issuances to a competitive auction of at least three banks that compete to sell these investment products. It appears, however, that some of the banks may have been rigging the public bid process in order to pay municipalities a lower rate on these investments.

In these cases, banks allegedly bribed the auctioneers/brokers who arranged the auction.[15] In return, the middleman broker would tell the prearranged winner what the other bids were, allowing the bank to lower its offer and come in with an interest rate just high enough to "beat" the supposed competitors. The winning bank then provided the middleman broker with a reward disguised as a fee. This process has been termed the "last look." Similarly, in other cases, banks conspired to deliberately submit non-winning bids in order to allow other banks to win the bid. This practice is known as a "set-up." By shaving even fractions of a percent off the winning bid, banks have allegedly pocketed large sums of money over the lives of multimillion-dollar bond deals.[16] Meanwhile, bond issuers have incurred significant losses as a result of receiving lower returns on these municipal derivative investments than they would have received in a free market.

Several bank executives have already been convicted on fraud and conspiracy counts for their involvement in the bid-rigging scandal. For example, on May 11, 2012 three former GE Capital executives were found guilty on charges of participating in several rigged bids

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