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Feature

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For years, observers have warned of the looming threat of unfunded pension liabilities. Some dubbed the danger the "pension tsunami," and it has hit an increasing number of U.S. cities, including Vallejo, Stockton and San Bernardino in California and the city of Detroit, which have sought chapter 9 relief in bankruptcy court.[1] Despite the attention given to these cases, chapter 9 filings are relatively scarce, and many significant issues remain to be resolved by the courts. One unanswered question is whether a municipal debtor in bankruptcy can propose to pay its pension debt[2] less than in full, even when applicable state constitutional provisions provide that such obligations must not be impaired.

Defined Benefit Pension Plans and the Funding Gap

Under a "defined benefit pension plan," an employee is guaranteed a specified pension benefit upon retirement. The amount to be paid is determined by a formula that is typically based on the employee's earnings history, length of employment and age. Significantly, the ultimate payout to retirees is not based on investment returns.

Although many cities have long offered defined benefit pension plans to its employees, few have adequately saved to cover these future costs. A report released by the Pew Charitable Trusts earlier this year found that although cities have promised pensions, health care and other benefits to retirees, "few ... [have] started saving to cover the long-term costs."[3] The Pew report explains that pension underfunding occurs as a result of the "[f]ailure to faithfully pay annual retirement bills" and "when investments and other assumptions fail to meet expectations and when benefits are increased without a way to pay for them."[4] What this underfunding means, of course, is that when these obligations come due, a city might have no means by which to satisfy them.

State Constitutional Protections

The ultimate goal of a chapter 9 filing is the confirmation of an adjustment plan that implements a comprehensive restructuring proposal that is feasible — meaning not only that the plan will work in the near term, but that it will also provide the municipality with, to the extent possible, a stable financial future. Under some circumstances, a municipal debtor might determine that it is impossible to propose a feasible restructuring plan that includes the payment in full of all pension obligations owed by a city.

Many state constitutions, however, purport to protect public-sector pensions,[5] considering such obligations to be "sacred cows." Michigan's Constitution, for example, provides that pension obligations constitute "a contractual obligation ... [that] shall not be diminished or impaired."[6] Such protections lead to an inevitable question: Assuming

1 Assuming that eligibility requirements are met, a municipality may file for bankruptcy under chapter 9 of title 11 of the U.S. Code.

2 This article will focus on pension debt as a vested, pre-petition obligation, meaning that the obligation was owed as of the date of the bankruptcy filing. Some pension obligations of this nature flow from collective-bargaining agreements, which may still be executory contracts and subject to potential rejection in bankruptcy. This article will not separately analyze those pension obligations that might be deemed a part of "rejection damages" by virtue of the rejection of a related collective-bargaining agreement as distinct from other pre-petition, accrued pension obligations. Rather, this article will address the question of whether, as a general matter, vested pension obligations may be reduced in municipal bankruptcy, similar to other pre-petition, unsecured debt obligations, where applicable state law provides that such obligations may not be impaired.

3 *A Widening Gap in Cities – Shortfalls in Funding for Pensions and Retiree Health Care*, Pew Charitable Trusts report, Jan. 2013, at 2, www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Retirement_security/Pew_city_pensions_report.pdf.

4 *Id.* at 7.

5 *See, e.g.*, N.Y. Const. art. V, § 7; Ill. Const. art. XIII, § 5.

6 Mich. Const. art. IX, § 24.

that the necessary requisites under the Bankruptcy Code are met,[7] can the Code be used to permit a municipality to pay its pension obligations less than in full, despite state constitutional protections that provide that such rights may not be diminished or impaired?

The Detroit Example

Detroit provides a striking example of a city struggling to continue to cover current debt obligations and operating expenses while facing significant unfunded obligations to retirees. Earlier this year, **Kevyn Orr**, Detroit's emergency manager, released the City of Detroit Proposal for Creditors (the "Detroit proposal"), which recommends a plan to restructure the city's debt. Regarding the city's defined benefit pension plans, the report states that the city's unfunded actuarial accrued liability (UAAL) is significant and has likely been considerably understated. By using "more realistic assumptions," the analysis "suggests that pension UAAL will be approximately $3.5 billion as of June 30, 2013."[8] Under the Detroit proposal, the amount to be paid on such claims "will be substantially less than the underfunding amount, [and thus,] there must be significant cuts in accrued, vested pension amounts for both active and currently retired persons."[9]

Unions and retiree groups have voiced their staunch opposition to the proposal, arguing that the Michigan Constitution prohibits a bankruptcy filing that proposes to impair vested pension obligations. Michigan's attorney general also opposes reducing pension obligations, arguing that "a bankruptcy filing does not relieve the City and its emergency manager of their obligation to follow Michigan's Constitution. And that restriction includes the constitutional provision that prohibits a political subdivision like Detroit from diminishing or impairing an accrued financial benefit of a pension plan or retirement system."[10]

Chapter 9 and the Conflicts with State Law

Guiding principles gleaned from case law analyzing, in the chapter 9 context, the intersection of state law protections and the Bankruptcy Code suggest that state constitutional provisions that merely assert that pension obligations are contractual rights that cannot be impaired may not shield those obligations from adjustment in bankruptcy. In *In re City of Vallejo*,[11] the court considered whether a municipal debtor could reject collective-bargaining agreements without adhering to state laws. This decision provides a clear and succinct discussion of the interplay between federal and state law in the chapter 9 context. The court explained that the "United States Constitution authorizes Congress to enact uniform bankruptcy laws" and that "[b]y virtue of the Supremacy Clause, federal laws are the supreme law of the land, notwithstanding state laws to the contrary."[12] The Tenth Amendment, however, states that powers not delegated to the federal government or prohibited are "reserved to the states." "To harmonize these two competing interests — reservation of powers to the states and the supremacy of federal bankruptcy law — Congress enacted 11 U.S.C. § 903."[13] As explained by the court in *In re County of Orange*, pursuant to § 903, the court "cannot interfere with the [municipality's] ability to continue its operations or dictate what type of services or level of services the debtor municipality may provide."[14] Section 903, however, "does not provide an independent substantive limit on the application of chapter 9 provisions."[15]

The *Vallejo* court found that the city could reject its collective-bargaining agreements without adhering to state laws and explained that "Section 903, together with 11 U.S.C. § 109(c)(2), allows states to act as gatekeepers to their municipalities' access to relief under the Bankruptcy Code."[16] When a state authorizes its municipalities to file a chapter 9 petition, as is required for a municipality to be eligible to file,[17] the state "declares that the benefits of chapter 9 are more important than state control over its municipalities."[18] The court further determined that "[b]y authorizing the use of chapter 9 by its municipalities, California must accept chapter 9 in its totality; it cannot cherry-pick what it likes while disregarding the rest."[19]

The issue of federal pre-emption in chapter 9 was recently addressed in *In re City of Stockton*.[20] In that case, retirees filed an adversary proceeding seeking injunctive relief to prevent Stockton, Calif., from unilaterally cutting retiree health benefits. Retirees asserted that they had vested contractual rights that were protected from impairment by the Contracts Clause of the U.S. Constitution, which prohibits the impairment of contracts, and by a similar clause in the California Constitution.

The bankruptcy court disagreed and denied injunctive relief. In reaching its conclusion, the court considered the retirees' assertion that their benefits were protected by the Contracts Clause of the U.S. Constitution. The court explained that the Contracts Clause bans a *state* from making a law that impairs a contract, but "does not ban Congress from making a law impairing the obligation of a contract."[21] The court further explained that "[t]he goal of the Bankruptcy Code is adjusting the debtor-creditor relationship. Every discharge impairs contracts."[22] Further, the court found that pursuant to the Supremacy Clause of the Constitution, the same analysis applies to the contracts clause in the California Constitution. Thus, the California Contracts Clause does not protect against the impairment that is authorized under the

7 The standards for plan confirmation in a chapter 9 case include both the statutory requirements of 11 U.S.C. § 943(b) and those portions of 11 U.S.C. § 1129 made applicable to chapter 9 cases by 11 U.S.C. § 901(a).

8 Detroit Proposal at 24.

9 *Id.*

10 Michigan Attorney General Bill Schuette's Statement Regarding the Michigan Constitution and the Bankruptcy of the City of Detroit at 2. (Case No. 13-53846; Docket #481). Similar issues have been raised in the *Stockton* and *San Bernardino* bankruptcy cases. While this issue is currently being litigated in the bankruptcy courts, it is an issue that will likely ultimately be addressed by the U.S. Supreme Court.

11 403 B.R. 72 (Bankr. E.D. Cal. 2009).

12 *City of Vallejo*, 403 B.R. at 75.

13 *Id.*

14 *In re County of Orange*, 191 B.R. 1005, 1018 (Bankr. C.D. Cal. 1996).

15 *City of Vallejo*, 403 B.R. at 75.

16 *Id.* at 76.

17 Among other requirements, in order for a municipality to be a debtor in bankruptcy, a municipality must be authorized by the state to file for bankruptcy. 11 U.S.C. § 109(c)(2).

18 *Id.* at 76.

19 *Id.* (citing *In re County of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996)). On appeal, the district court affirmed the *Vallejo* decision and found that the California statute authorizing a municipal bankruptcy did not limit the rejection of employee contracts as a precondition to filing for bankruptcy. It also found that the state's "failure to take such action convinces this Court that the City was unequivocally authorized to exercise its right under Section 365 and reject [the agreements] without interference from the state." *In re City of Vallejo*, 432 B.R. 262, 270 (Bankr. E.D. Cal. 2010). Some argue that a state might be permitted to pre-ordain certain claims, such as pension claims, as protected from impairment in bankruptcy as a *precondition* to its granting the municipality the right to file for bankruptcy. Whether such legislation would be viewed as a legitimate attempt to circumscribe access to bankruptcy or whether, conversely, such action would be perceived as an illegitimate attempt to delimit the efficacy of chapter 9 (such that municipalities in that state might be judicially interpreted as not truly having access to chapter 9) remains to be seen.

20 2012 WL 3193588 (Bankr. E.D. Cal.).

21 *In re Stockton* at *2.

22 *Id.* at *3.

Bankruptcy Code. "In sum, even if the plaintiffs' benefits are vested property interests, the shield of the Contracts Clause crumbles in the bankruptcy arena."[23]

In the earlier case of *In re Orange County*,[24] the county alleged that it was entitled to certain proceeds held by the defendant. The defendant argued that under California law, the proceeds had been held in trust for its benefit and were not property of the county. The court held that bankruptcy law dictates whether the funds are property of the county. The court explained that under bankruptcy law, "a creditor beneficiary ... must be able to trace its funds, otherwise the funds become property of the debtor."[25]

Under California law, tracing was not required. The application of this law in bankruptcy, the court explained, would allow the state to create a special class of protected creditors in bankruptcy. The court held that "[c]hapter 9 does not permit individual states to override the priority scheme that is inherent in the Code." The court further found that "simply because Congress did not incorporate § 507(a)(2) through (a)(9) into chapter 9 does not lead to the sweeping, and potentially chaotic, conclusion that Congress intended to eliminate the federal priority scheme in chapter 9."[26]

Conclusion

Several key principles emerge from these cases, which include the following:

- Congress — and not the individual states — is authorized by the Bankruptcy Clause to enact uniform bankruptcy laws, a central component of which is the impairment of contracts;
- The Bankruptcy Code establishes a federal priority scheme that is not overridden by state law in the chapter 9 context;
- Once a municipal debtor is in bankruptcy, the right to accept or reject collective-bargaining agreements is governed by federal law; and
- Although a state may control the prerequisites for permitting its municipality to file a chapter 9 case, it cannot revise chapter 9 and must accept chapter 9 in its totality.

Based on these guiding principles, state constitutional provisions that merely assert that accrued pension benefits are vested contractual rights and are not subject to impairment or reduction may not provide protection in chapter 9 against an attempt by a municipal debtor to pay those obligations less than in full. First, to the extent that such provisions attempt to create a special class of protected unsecured creditor that does not exist under the Bankruptcy Code, such provisions may be rejected as an improper encroachment on the federal priority scheme. Further, as repeatedly recognized by the courts, a state cannot cherry-pick the Code provisions that it wishes to permit its municipalities to utilize. When it decides to permit its municipalities to file for bankruptcy protection, it must accept chapter 9 in its entirety.

Although it is beyond the scope of this article, it bears noting that if vested pension benefits are subject to reduction in bankruptcy, the question of how such claims should be treated *vis-à-vis* other creditors and exactly what the concept of "unfair discrimination" — a standard that must be met for a plan to be approved over creditor objections[27] — should mean in this context will undoubtedly raise multifaceted and complex issues that will need to be considered and addressed.

Finally, if the courts were to rule in favor of protecting pensions, this result would mean that bondholders, believed by some to have been protected by full faith and credit, would likely be required to bear much more of the needed concessions. Such a result would likely lead to the increased cost for municipal credit, both for the restructuring municipality and otherwise. This potential eventuality highlights the tension between a state's desire to protect its public retirees on the one hand, and on the other hand, the competing consideration of the risk of seriously rising costs of municipal finance throughout the state if bondholders are required to shoulder needed concessions because reducing retiree benefits is determined to be prohibited. abi

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23 *Id.*
24 *In re County of Orange*, 191 B.R. 1005 (C.D. Cal. 1996).
25 *Id.* at 1015 (citations omitted).
26 *Id.* at 1021.
27 11 U.S.C. § 1129(b)(1).