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Is It Fair to Discriminate in Favor of Pensioners in a Chapter 11 Plan?

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Feature

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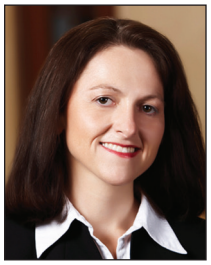

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A number of U.S. cities are plagued with debt obligations that cannot be met. As municipalities[1] have turned to chapter 9 protection to ease their financial burdens, various creditor constituencies have found themselves pitted against each other as they realize that they might be forced to share a finite amount of assets and funds that are insufficient to cover all of the a municipality's debts.

The ultimate goal of a chapter 9 filing is the confirmation of an adjustment plan that implements a feasible and comprehensive restructuring of a municipality's obligations. A municipality's proposed plan must be approved by the bankruptcy court. One significant question that has been brought to the forefront in the bankruptcy cases of Detroit and Stockton, Calif., is whether a proposed plan might be approved despite the fact that it provides a substantially greater share of recoveries to pensioners, compared with the recoveries offered to other creditors of the same priority.[2]

This article discusses the prohibition against unfair discrimination for purposes of plan confirmation in the chapter 9 context. Specifically, it examines factors that a court might consider that could lead it to confirm an adjustment plan under circumstances whereby the plan proposes to pay pensioners — also a class of unsecured creditors — a higher percentage of their claims compared with the payouts proposed to the dissenting class of unsecured creditors.[3]

The Prohibition Against Unfair Discrimination

The standards for plan confirmation in a chapter 9 proceeding 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 by 11 U.S.C. § 901(a). Section 1129(b) is one key provision of chapter 11 that is applicable to a chapter 9 plan. Under this provision, if at least one impaired class of creditors consents to the plan, a plan may be confirmed over the objection of other creditors — known as the "cramdown" power.

Assuming that the plan otherwise meets the requirements for confirmation, cramdown permits a court to approve a plan over creditor objections if two criteria are met: the plan (1) is "fair and equitable" and (2) does not "discriminate unfairly" with respect to any class of creditors that the plan proposes to impair.

The Detroit and Stockton Examples

The prohibition against "unfair" discrimination has been a hotly contested issue in the Detroit bankruptcy proceeding. Earlier this year, Detroit filed its adjustment plan whereby it proposed substantially greater recoveries for pensioners than the recoveries proposed for certain other unsecured claimholders. The amount of the anticipated discrepancy is the subject of dispute — with Detroit claiming that the recovery differential is much less than the discrep-

1 The Bankruptcy Code defines a "municipality" as a "political subdivision or public agency or instrumentality of a State." *See* 11 U.S.C. § 101(40) (2006). In addition to encompassing cities and counties, the term also includes certain public agencies, special-use districts and authorities.

2 In both cases, pension advocates have argued that pension benefits are entitled to special protection in bankruptcy. In response to this position, the judges in the *Detroit* and *Stockton* cases have both ruled in prior decisions that pension benefits are subject to potential reduction in bankruptcy. For the relevant decision in the *Detroit* case, *see In re City of Detroit*, 504 B.R. 97 (Bankr. E.D. Mich. 2013). For a discussion of the *Stockton* decision, *see* Katy Stech and Dan Fitzpatrick, "Judge Says Cities in Bankruptcy May Reject Pension Contracts," *Wall St. Journal* (Oct. 1, 2014), *available at* http://online.wsj.com/articles/judge-says-cities-in-bankruptcy-may-reject-pension-contracts-1412202138; Dale Kasler, "Judge Rules Stockton Can Sever CalPERS Pensions, Wall Street Approves," *Sacramento Bee* (Oct. 10, 2014), *available at* www.sacbee.com/news/business/article2617413.html.

3 This article focuses on factors that might be of particular or unique importance in the chapter 9 context. It does not focus on factors that are not necessarily of particular importance in the chapter 9 context (such as the desire or need to provide for certain recoveries to creditors with whom the debtor has reached an agreed-upon resolution).

ancy claimed by objecting creditors. Even under the numbers offered by Detroit, pensioners will still receive a significantly greater recovery than many other unsecured creditors.[4] Although most creditor groups have settled their objections with Detroit, a number of creditors initially objected vehemently to the plan, arguing that it unfairly discriminates against certain unsecured creditor classes by, among other things, providing substantially greater recoveries to pensioners.[5]

Similarly, the bankruptcy plan of Stockton proposes to pay certain unsecured creditor groups substantially less than it proposed to pay its pensioners. Although other creditor groups settled their objections, Franklin Resources Inc. continued to maintain its objection to the proposed plan. In a decision issued as this article was being written, Judge Klein has approved the Stockton plan over creditor objections.[6] Of course, Franklin Resources might choose to appeal this decision. Regardless of whether the decision is appealed, the fact that this question has been squarely addressed and decided in the pensioners's favor will undoubtedly yield reverberations across the nation, as bondholders and other creditor groups grasp the notion that pensioners could potentially be heavily favored in a chapter 9 plan.[7]

"Unfair" Discrimination, Generally

Under § 1129(b)(1), a proposed plan may discriminate against a nonaccepting impaired class in its distribution to that dissenting class, provided that the discrimination is not "unfair." The concept of "unfair" discrimination is not defined in the Bankruptcy Code.

In the chapter 11 context, courts have developed a variety of tests to evaluate whether a discriminatory treatment will be deemed unfair. Many courts follow the test of *In re Aztec Co.*[8] and consider the following: (1) whether the discrimination is supported by a reasonable basis, in fact; (2) whether the debtor can confirm and consummate a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) the treatment of the classes being discriminated against.[9]

Other courts have adopted a "rebuttable presumption test": unfair discrimination is presumed where there is (1) a dissenting class, (2) another class of the same priority, and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments) or (b) regardless of the percentage recovery, an allocation under the plan of materially greater risk to the dissenting class.[10] For the plan proponent to rebut the presumption, it must show that outside of bankruptcy, the dissenting class would receive less than the class receiving a greater recovery, or that the alleged preferred class had infused new value that offset its gain.[11] Some courts eschew formulaic tests for unfairness and simply assert that a court has wide latitude to approve disparate treatment if it finds that the disparate treatment is justified.[12]

[D]ecisions in the chapter 9 context underscore the importance of considering the impact of any adjustment plan on a municipality's citizenry.

Regardless of the standard that has been utilized, it is clear that "the prevailing view is that the minimum requirements for finding that a chapter 11 plan does not unfairly discriminate are that it has a rational or legitimate basis for discrimination and the discrimination must be necessary for the reorganization."[13] It is also clear that determining whether any disparate treatment is "unfair" requires a fact-intensive analysis of the circumstances in each proceeding. Nonetheless, courts have considered certain factors in approving plans that propose unequal treatment of creditors of the same priority that should be instructive when considering whether a given adjustment plan might be approved despite the fact that it treats pensioners more favorably than other unsecured creditors.

Importance of Maintaining Relationships

First, and particularly relevant here, is the fact that in determining whether disparate treatment is permissible (*i.e.*, not "unfair"), a court might consider whether the proposed discrimination protects a relationship with specific creditors that the debtor needs to successfully reorganize. For example, in *In re Kliegl Bros. Universal Elec. Stage Lighting Co.*, the court confirmed a plan that provided a 75 percent recovery on a union's general unsecured claim and a 15 percent recovery on other general unsecured claims. The court found that the "[d]ebtor's ability to continue to operate a union shop [is] absolutely critical to its ability to function successfully in its industry."[14]

In *In re Creekstone Apartments Associates LP*,[15] the court confirmed a chapter 11 plan that provided for only a 10 percent payment on an unsecured creditor's claim while paying unsecured trade creditors in full. The court approved such disparate treatment because it found that the payment of trade creditors was necessary to permit the debtor to maintain relationships with the debtor's vendors, and that those relationships were critical to the success of the reorganization. Similarly, in *In re Johnston*,[16] the court held that a plan may provide for payment to the

4 Under its plan, the city estimates an overall recovery of approximately 60 percent on its pension claims, while certain other unsecured creditors under the plan are estimated to receive recoveries of as little as 10 percent.

5 The Detroit plan involves a cash infusion from third-party sources that are to be directed to the satisfaction of Detroit's pension obligations. The city argues that funds that are contributed by third parties should not be considered in the unfair-discrimination analysis. This issue is beyond the scope of this article.

6 Under the city's plan, CalPERS will be paid in full, while Franklin Resources will receive only about 1 percent of the unsecured portion of its claim. For a discussion of the plan and this decision, *see* Michael Bathon, Alison Vekshin and Steven Church, "Stockton's Pension-Protecting Bankruptcy Plan Approved," *Bloomberg* (Oct. 30, 2014), *available at* www.bloomberg.com/news/2014-10-30/stockton-california-wins-court-approval-of-bankruptcy.html.

7 If other courts follow suit and rule in favor of favoring pension claimants to a significant degree, this result would likely mean that bondholders would be required to bare much more of the proposed concessions. Such a result would likely lead to increased cost for municipal credit, both for the restructuring municipality and otherwise.

8 *In re Aztec Co.*, 107 B.R. 585, 590 (Bankr. M.D. Tenn. 1989).

9 *See, e.g., In re Jim Beck Inc.*, 214 B.R. 305, 307 (W.D. Va. 1997).

10 *See, e.g. In re Tribune Co.*, 472 B.R. 223, 241 (Bankr. D. Del. 2012).

11 *In re Dow Corning Corp.*, 244 B.R. 696, 702 (Bankr. E.D. Mich. 1999).

12 *In re LeBlanc*, 622 F.2d 872, 879 (5th Cir. 1980); *see also In re Deming Hospitality LLC*, 2013 WL 1397458 (2013).

13 *Dow Corning Corp.*, 244 B.R. 705, 710 (Bankr. E.D. Mich. 1999) (internal citations omitted); *see also In re Dura Auto. Sys. Inc.*, 379 B.R. 257 (Bankr. D. Del. 2007).

14 *In re Kliegl Bros. Universal Elec. Stage Lighting Co.*, 149 B.R. 306, 309 (Bankr. E.D.N.Y. 1992).

15 *In re Creekstone Apartments Assocs. LP*, 168 B.R. 639, 644 (Bankr. M.D. Tenn. 1994).

16 *In re Johnston*, 21 F.3d 323, 328 (9th Cir. 1994).

trade creditor class sooner than the payment of tort claims in cases where the trade creditors are more critical to the debtor's reorganization.

A municipality could certainly argue, as Detroit has done, that it is vitally important for the municipality to maintain good relations with its pensioners, many of whom could be current employees and residents of the municipality. Further, even if the pensioners at issue are not current employees or residents, the individuals who are current employees of the municipality will undoubtedly be paying careful attention to the way that the municipality treats its retirees. Thus, a strong argument can be made that the municipality should be permitted to favor its pensioners in order to preserve relationships with its employees and/or residents — relationships that are vital to the municipality's survival.

Impact on Creditors and Others

In addition, a court may consider the impact that the proposed distribution will have on members of the creditor class or others in determining whether the proposed disparate treatment should be permitted. In *In re Chateaugay Corp.*, the court expressed the view that "Congress gave reorganizing debtors considerable flexibility in their treatment of general unsecured creditors to position themselves for future economic viability."[17] In *Chateaugay*, the court affirmed the approval of a plan that paid workers' compensation claims in full while providing other unsecured claimholders a 40 percent recovery.[18] The court noted that the workers' compensation was the claimants' "only form of wage replacement."[19]

Similarly, in *In re HRC Joint Venture*,[20] the court approved the separate classification and more favorable treatment of a city's unsecured claim in the chapter 11 case of a debtor/hotel owner. In this case, the court approved the transfer of an equity interest in the debtor to the city/creditor, noting that the "[c]ity has substantial noncreditor interests in a reorganized debtor" and that the "[d]ebtor's hotel is an important feature in the downtown area of the City ... the City has a vital interest in the availability of desirable hotel accommodations to service" the city's convention center.[21]

The potential impact of any proposed distribution on creditors and other interested parties is particularly relevant in the chapter 9 context because the purpose of chapter 9 is to confirm an adjustment plan that will permit the municipal debtor to continue to serve its constituents, many of whom are employees and pensioners. As one court observed, "unlike the other Chapters, Chapter 9 does not attempt to balance the rights of the debtor and its creditors, but rather, to meet the special needs of a municipal debtor."[22]

Moreover, decisions in the chapter 9 context underscore the importance of considering the impact of any adjustment plan on a municipality's citizenry. For example, in *In re Barnwell County Hospital*,[23] the court observed that "of particular importance to the Court is that the Plan preserves the availability of health care services to citizens and patients in the County."[24] Similarly, a separate court emphasized that "[t]he primary purpose of [a] debt restructure for a municipality is not future profit, but rather continued provision of public services."[25]

Conclusion

Guiding principles developed in both the chapter 9 and 11 contexts suggest that there are situations where a court might approve a plan that favors pensioners over other unsecured creditors. However, the limited case law assessing chapter 9 plans, and the fact-specific analysis that is employed by the courts in determining whether disparate treatment is unfair, instructs that the unique nature of a municipality, its relationship to its citizens (including pensioners and current employees) and the purposes of chapter 9 must be key parts of the analysis. The recent *Stockton* decision illustrates that approval of a plan that favors pension debt is possible. When it is issued, the written decision in that case should provide significant insight on the analysis that a court might undertake when reaching a decision on whether to favor pensions over other unsecured creditors. abi

Editor's Note: *For more information, purchase* Municipalities in Peril: The ABI Guide to Chapter 9, Second Edition *(ABI, 2012), available for purchase at abi.org/bookstore (members must log in first to obtain the member price).*

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17 *Aetna Cas. & Surety Co. v. Clerk (In re Chateaugay Corp.)*, 89 F.3d 942, 949-50 (2d Cir. 1996).

18 *In re Chateaugay Corp.* addressed whether the classification of a particular claimant in a class separate from the favored class was justified under 11 U.S.C. § 1122(a). However, cases decided under § 1122(a) are nonetheless instructive here because disparate treatment often results from the approval of the separate classification of claims. In addition, §§ 1122(a) and 1129(b)(1) are often considered in conjunction and often involve an analysis of the same basic question: whether the proposed differential treatment is justified under the circumstances.

19 *In re Chateaugay Corp.*, 89 F.3d at 949.

20 *In re HRC Joint Venture*, 187 B.R. 202 (Bankr. S.D. Ohio 1995).

21 *Id.* at 216.

22 *In re Richmond Unified Sch. Dist.*, 133 B.R. 221, 225 (Bankr. N.D. Cal. 1991); *see also In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 34 (Bankr. D. Colo. 1999) ("[I]t would make little sense to confirm a reorganization plan [that] does not remedy the problem. Stated differently, there is no purpose in confirming a Chapter 9 plan if the municipality will be unable to provide future governmental services.").

23 *In re Barnwell County Hosp.*, 471 B.R. 849 (Bankr. D.S.C. 2012).

24 *Id.* at 869.

25 *In re Mount Carbon Metro. Dist.*, 242 B.R. at 34.