Want to Preclude Municipal Bankruptcies Filed to Discharge Pension Obligations? Amend Your Bankruptcy Authorization Statute, Pronto

By: Marc Lieberman

Financially-strapped cities, towns and counties ("Municipalities") are increasingly filing bankruptcy in an effort to discharge or reduce their public pension obligations.[1] Federal law allows Municipalities (but not states[2]) to seek protection under Chapter 9 of the United States Bankruptcy Code (the "Code"), *but only in the event such recourse is permitted by state law. See* 11 United States Code ("USC") § 901 *et seq.* Many states impose restrictions and qualifying criteria upon Municipalities attempting to file for Chapter 9 bankruptcy, with only about half of the states specifically authorizing Municipalities to file.[3] Only 12 states specifically authorize Chapter 9 bankruptcy filings by Municipalities without condition.[4]

This article will briefly discuss the major issues arising in connection with a municipal bankruptcy, if only to emphasize that public pension benefits might indeed be subject to impairment in municipal bankruptcy proceedings, despite state constitutional provisions precluding such impairment. The article will then propose prophylactic measures to preclude such filings altogether.

The Prerequisites of a Municipal Bankruptcy Filing

To qualify for relief under Chapter 9 of the Code, a Municipality must not only have authority under state law to file for bankruptcy but must also be: (i) insolvent; (ii) willing to effectuate a plan of readjustment; and (iii) either have (a) obtained the agreement of creditors holding a majority amount of the claim of each class of debt that the Municipality intends to impair, or (b) have attempted to negotiate in good faith, but was unable to do so or it was impractical to negotiate with creditors (or a creditor has attempted to obtain a "preference"[5]).[6] In those cases where state law authorizes Municipalities to seek relief in bankruptcy, it is presumed that they will be willing to effectuate a plan of readjustment if they file for relief under Chapter 9 of the Code. Thus, upon any initial filing, the initial contest will concern whether the Municipality filing for relief (the "Debtor") is really insolvent and further, whether it attempted to negotiate with its creditors in "good faith" but was unable to do so or it was impractical to negotiate (or a creditor attempted to obtain a preference).

The Interplay of Constitutional Protections for Public Pension Benefits

Assuming such concerns are overcome, the real dispute will then turn on whether the Debtor can propose to pay less than its full pension obligations, despite state constitutional provisions protecting pensions from impairment. For example, in Arizona, Art. XXIX, § 1(C) of the Arizona Constitution specifically protects public pensions from legislative impairment, as follows:

> Membership in a public retirement system is a contractual relationship that is subject to Article II, section 25, and public retirement system benefits shall not be diminished or impaired.

Art. XXIX, § 1(C) has been construed as having two separate parts: the "Contract Clause" and the "Pension Clause."[7] The Contract Clause is the first half of the provision referencing Art. II, § 25 of the Arizona Constitution. Facially, Art. II, § 25 prohibits the government's impairment of existing contracts:

> No... law impairing the obligation of a contract, shall ever be enacted.

Despite the fact that the language of the Contract Clause appears absolute, the courts have construed it to permit legislation to impair contractual rights *if* certain elements are satisfied.[8]

The second half of Art. XXIX, § 1(C) of the Arizona Constitution is the "Pension Clause," which provides:

> public retirement system benefits shall not be diminished or impaired.

The Arizona Supreme Court has held that whereas the Contract Clause "applies to the general contract provisions of a public retirement plan," the "Pension Clause applies only to public retirement benefits," and confers "additional independent protection afforded by the Contract Clause."[9] The Court has further held that whereas the Contract Clause permits legislation to impair contractual rights if certain elements are satisfied, the Pension Clause does not permit legislation to diminish or impair retirement benefits under *any* circumstances.[10]

In light of such pronouncements, can Municipalities use Chapter 9 of the Code to reduce or even discharge their pension obligations to their employees, since such an act will definitely diminish or impair the employees' pension benefits? As of this writing, the answer to that question is unclear, although preliminary indications suggest that bankruptcy courts might indeed authorize the impairment of pensions for *active* as opposed to *retired* government workers.

The Detroit Experience

The events unfolding in the State of Michigan as a result of the Detroit bankruptcy filing may provide insight concerning what other bankruptcy courts might do.

Michigan law allows Municipalities to file for relief under Chapter 9 of the Code if certain circumstances are present (*see* Mich. Comp. Laws § 141.1222). Further, Art. IX, § 24 of Michigan's constitution includes language similar to the Pension Clause in the Arizona

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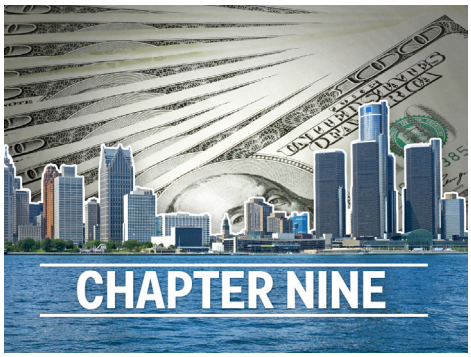
Constitution. Under Art. IX, § 24 of the Michigan Constitution, pension obligations constitute "a contractual obligation... [that] shall not be diminished or impaired." Thus, the U.S. Bankruptcy Court's recent decision in *In re City of Detroit*,[11] wherein the court concluded that Chapter 9 of the Code permits the City of Detroit to reduce the pensions of its employees, despite language in the Michigan Constitution precluding diminishment or impairment of pension obligations, may be a harbinger of what a bankruptcy court in your state might find.



In the *Detroit* case, the bankruptcy court concluded that accrued pension benefits can be adjusted in Chapter 9, notwithstanding state laws prohibiting impairment.[12] The court's rationale was as follows:

Art. I, § 8, cl. 4 of the United States Constitution states that "Congress shall have the power... to establish... uniform laws on the subject of bankruptcies throughout the United States...." Pursuant to this authority, Congress enacted the Code, which explicitly empowers bankruptcy courts to impair contractual rights relating to accrued vested pension benefits.[13] Thus, while state constitutional provisions preventing the diminishment or impairment of pension contracts are enforceable to prevent a *State* from impairing pension rights, they do not prevent *federal* bankruptcy courts from doing so, for "[i]mpairing contracts is what the bankruptcy process does."[14] The court explained:

> In other words, while a state cannot make a law impairing the obligation of a contract, Congress can do so. The goal of the Bankruptcy Code is adjusting the debtor-creditor relationship. Every discharge impairs contracts. While bankruptcy law endeavors to provide a system of orderly, predictable rules for treatment of parties whose contracts are impaired, that does not change the starring role of contract impairment in bankruptcy. It follows, then, that contracts may be impaired in this Chapter 9 case without offending the Constitution. The Bankruptcy Clause gives Congress express power to legislate uniform laws of bankruptcy that result in impairment of contract; and Congress is not subject to the restriction that the Contracts Clause places on states.[15]

Since pension rights arise out of a contract, the court concluded that pension rights can be impaired by federal bankruptcy law so long as the state consents to be subject to federal bankruptcy laws.[16] "It follows that if a state consents to a municipal bankruptcy, no state law can protect contractual rights from impairment in bankruptcy, just as no law could protect any other type of contract rights."[17] The court further emphasized, "Stated another way, state law cannot reorder the distributional priorities of the bankruptcy code. If the state consents to a municipal bankruptcy, it consents to the application of chapter 9 of the bankruptcy code."[18]

The Court's Rejection of Section 903 Defenses

In due recognition of each state's sovereignty, Section 903 of the Code reserves certain powers to the states during the pendency of a municipal bankruptcy, and several retirement systems have argued that this section precludes bankruptcy courts from impairing government pension rights which are otherwise protected from impairment by state laws.[19]

Section 903 of the Code states:

> This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—
>
> **(1)** a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and
>
> **(2)** a judgment entered under such a law may not bind a creditor that does not consent to such composition.

Pursuant to § 903 of the Code, bankruptcy courts 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."[20] Section 903, however, "does not provide an independent substantive limit on the application of chapter 9 provisions."[21] In the Detroit bankruptcy proceedings, the City's retirement systems argued that § 903 of the Code required Michigan's constitutional protections for pensions to preempt the bankruptcy court's power to impair municipal contracts, but the court flatly rejected such arguments:

> A state cannot rely on the § 903 reservation of state power to condition or to qualify, i.e., to "cherry pick," the application of the Bankruptcy Code provisions that apply in chapter 9 cases after such a case has been filed. [Citations omitted]. **While a state may control prerequisites for consenting to permit one of its municipalities (which is an arm of the state cloaked in the state's sovereignty) to file a chapter 9 case, it cannot revise chapter 9** [Citations omitted].[22]

The retirement systems have appealed the Bankruptcy Court's decision to allow impairment of pension rights,[23] and perhaps only after that appeal is decided will we have better clarity whether public pension rights are subject to impairment in a Chapter 9 bankruptcy despite state constitutional prohibitions against the diminishment or impairment of retirement benefits.

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Of course, if public retirement benefits can be impaired through a municipal bankruptcy, left unanswered is how precisely retirement benefits are to be treated in any plan of adjustment. This will depend on the condition of each Municipality, the other creditor constituents, and many other factors not capable of being readily surmised here. Nevertheless, the broad outlines of how the bankruptcy court might impair pension benefits can be gleaned from the few cases in which such matters have been addressed.

Possible Application of the Bankruptcy Code to State Pension Plans

Several provisions of the Code will apply to pension benefit claims. The most powerful is Code § 365, which governs the assumption or rejection of "executory contracts." An executory contract is one which has not yet been fully performed or, put another way, a contract under which both sides still have important performances remaining.[24] Under Code § 365, the Debtor (*i.e.*, the delinquent participating employer) may elect to "reject" an executory contract. In the pension context, a Municipality may argue that the pension rights of its active (in contrast to its retired) members are executory contracts which can be rejected.

If the right to a pension is determined to be an executory one, then pursuant to Code § 365 (as made applicable to Chapter 9 proceedings pursuant to Code § 901), the pension may be rejected.[25] The effect of rejection is that the contract is terminated and any damages as a result of the termination are treated as an unsecured claim that arose prior to the bankruptcy filing. Thus, the priority of the claim is the last rung of the claims to be paid out of available monies.

Whether a pension right is executory may be dependent upon whether it is "vested." In Arizona, for example, a right is "vested" when "the right to enjoyment, present or prospective, has become the property of some particular person or persons as a present interest."[26] Under another formulation, a right "vests" under Arizona law when "it is actually assertable as a legal cause of action or defense or is so substantially relied upon that retroactive divestiture would be manifestly unjust."[27]

Under Arizona law then, the right to government pension benefits "vests" "upon the commencement of employment."[28] And also under Arizona law, after such vesting, "[the pension] contract cannot be unilaterally modified nor can one party to a contract alter its terms without the assent of the other party."[29]

The Bankruptcy Courts are generally uniform in their decisions that vested benefits no longer satisfy the applicable definition of an executory contract and, therefore, cannot be rejected, so that benefits must continue to be paid and contributions for vested benefits must be made, *to the extent of available monies*. In the municipal bankruptcy context, however, the issue of whether rights are vested or unvested is likely to be determined based on *federal*, not state law, albeit the determination under federal law should be guided by state law.[30]

Generally, the bankruptcy courts in addressing private sector pension plans have concluded that, upon an employee's *retirement*, the contract between the parties is fully performed, and is no longer executory.[31] Conversely, the Bankruptcy Courts addressing private sector pension plans have also generally concluded that the pension rights of active employees may be executory contracts which can be rejected or modified, which has occurred in at least two bankruptcies.[32] Even the rights of vested pension plan participants may be modified as a result of negotiations. For instance, in municipal bankruptcies of the City of Pritchard, Alabama and Central Falls, Rhode Island, vested pension plan rights were modified through the plan process as a result of negotiations.[33]

Thus, under the current state of the law, the pensions of current employees may be characterized as executory, subject to rejection in bankruptcy. The effect of rejection is termination of the contract and a resulting unsecured claim for the damages flowing from the termination. In contrast, the pensions of retired pensioners are likely to be characterized as "vested," and therefore, not subject to rejection. Accordingly, benefits payable to retirees must continue to be paid, notwithstanding any bankruptcy filing, although the issue then will become whether the payments are unsecured claims (because they arise from a pre-bankruptcy filing contract, which then means the claims may be subject to reduction in any plan of reorganization), or whether they are "administrative" claims (which in bankruptcy must be paid in full on the effective date of any plan of reorganization).[34] For purposes of brevity, we leave discussion of that issue to another day. One thing is certain: in the event pension rights are challenged in bankruptcy, there will be substantial litigation about how vested pension rights are to be characterized and therefore, prioritized for payment.

Prophylactic Legislation

Given the fact that to protect their members, state-wide public pension systems almost certainly will be drawn into any municipal bankruptcy of a participating employer, systems ought to consider whether to take prophylactic measures to preclude participating employers from discharging their pension obligations in bankruptcy. One relatively simple method of doing that would be to amend the state's bankruptcy authorization statute-- the statute which authorizes Municipalities to file bankruptcy under Chapter 9, to preclude Municipalities from filing for bankruptcy to discharge or reduce their public pension obligations. The case law addressing the authority of states to allow their Municipalities to file Chapter 9 petitions suggests that such a limitation might be enforceable.

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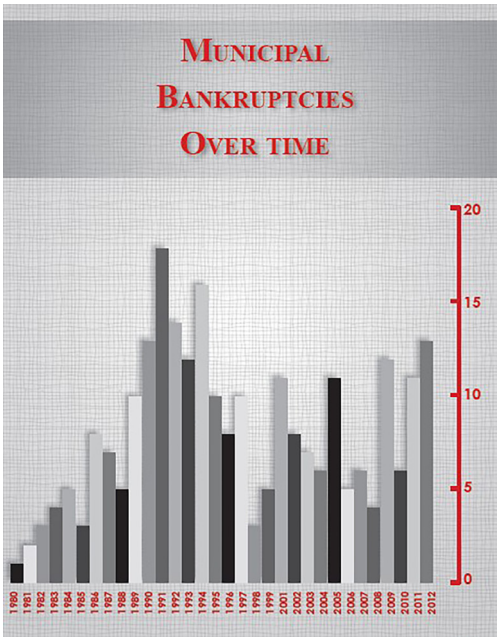
In *In re City of Vallejo*,[35] labor unions challenged the City of Vallejo's unilateral decision to modify its workers' collective bargaining agreements, arguing that state labor law prohibited impairment of the contracts.[36] The bankruptcy court disagreed, finding that language in Cal. Government Code § 53760, the statute which authorizes Municipalities to file for bankruptcy relief, did not "explicitly impose on California Municipalities limitations or restrictions that require compliance with or make applicable state labor laws."[37] Specifically, the court found that the language of this statute, which at the time provided that "except as otherwise provided by statute, a local public entity in this state may file a petition and exercise powers pursuant to applicable federal bankruptcy law" was not effective to carve out the labor agreements from the City's right to adjust its debts in bankruptcy. The unions argued that the language "except as otherwise provided by law" codified California's intent to allow Municipalities to file for bankruptcy only in certain circumstances, "but not to allow full preemption of all state laws in doing so."[38] In disagreeing with the unions, the court stated:



> This court declines to legislate from the bench and create a new exception to federal preemption. State labor law is not explicitly identified in California Government Code § 53760 as an exception to the general grant of authority for municipalities to pursue Chapter 9 bankruptcy. **If California had desired to restrict the ability of its municipalities to reject public employee contracts in light of state labor law, it could have done so as a pre-condition to seeking relief under Chapter 9. Its failure to take such action convinces this Court that the City was unequivocally authorized to exercise its right under Section 365 [of Chapter 9] and reject the [collective bargaining agreements] without interference from the state.**[39]

Thus, *City of Vallejo* acknowledges that in authorizing Municipalities to file for Chapter 9 bankruptcy, states may carve out certain debts from being adjusted in bankruptcy or limiting the debts a Municipality may adjust. In light of *City of Vallejo*, a public pension system might consider amending its particular bankruptcy authorization statute to preclude the discharge of public pension obligations. For example, the Arizona bankruptcy authorization statute-- A.R.S. § 35-603, could be amended as **(with material omitted reflected as ~~double strikeouts~~ and material added reflected by double underline):**

> Any taxing district or municipality in this state is authorized to file the petition provided for in the federal bankruptcy statute and to incur and pay the expenses thereof and any and all other expenses necessary or incidental to the consummation of the plan of readjustment contemplated in such petition or as may be modified from time to time, except that no municipality shall be empowered to petition for relief under the federal bankruptcy code, or seek relief therein, to diminish, impair, reduce, modify or discharge its public retirement system obligations in derogation of the rights afforded by Article XXIX, § 1(C) of the Arizona Constitution.

If enforceable, the above amendment would effectively preclude Arizona Municipalities from petitioning for bankruptcy to discharge or modify their contribution obligations. While the above amendment *might* well be enforceable, there is some risk that the "anti-discrimination rules" set forth in the bankruptcy Code might jeopardize the amendment's validity.

As explained above, a Municipality may file for bankruptcy under Chapter 9 of the Bankruptcy Code if state law authorizes such a filing. However, the goal of federal bankruptcy law is to allow for a "fair and equitable distribution to all creditors," such that all similarly-situated creditors have equal rights or access to the insolvent municipality's assets.[40] Congress' intent in allowing Municipal bankruptcy was to prohibit state law from conferring "preference on one class of creditors of one adjudged bankrupt under federal law even though the state may have the highest public purpose in attempting to do so."[41] Consequently, while states must grant authority for their Municipalities to be able to file bankruptcy under Chapter 9, once a state grants such authority, it "must accept Chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest."[42] To that end, "Chapter 9 does not permit individual states to override the priority scheme in the" Bankruptcy Code.[43] By way of example, in *In re County of Orange*, the bankruptcy court struck down as preempted a state law that gave priority to creditors holding a Municipality's funds in trust because the state law's priority conflicted with the priority scheme of the Bankruptcy Code.[44]

The upshot of the foregoing is that a bankruptcy court might find that *if* State law allows Municipalities to petition for relief under Chapter 9, State law cannot preclude certain Municipal debts (as opposed to others) from being discharged in bankruptcy. *If* that is the case, then allowing Municipalities to discharge all debts other than their public pension obligations would be unenforceable. On the other hand, the Code might allow states to preclude Municipalities from filing bankruptcy altogether if they have certain kinds of outstanding debts, and this is how the State of New York has addressed the issue. In New York, Municipalities cannot even petition for bankruptcy relief if they have certain kinds of outstanding debt.

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In 2009, the New York State Assembly amended its municipal bankruptcy law, N.Y. Local Finance Law § 85.80, to preclude municipalities from filing for Chapter 9 bankruptcy if the Municipality had outstanding local American Recovery and Reinvestment Act ("ARRA") bond obligations. This statute now provides:

> A municipality or its emergency financial control board in addition to, or in lieu of, filing a petition under this title, or the city of New York or the New York state financial control board, may file any petition with any United States district court or court of bankruptcy under any provision of the laws of the United States, now or hereafter in effect, for the composition or adjustment of municipal indebtedness. Nothing contained in this title shall be construed to limit the authorization granted by this section. However, **no municipality shall file any petition authorized by this section for so long as its local ARRA bonds, as defined in section twenty-four hundred thirty-two of the public authorities law, purchased by the state of New York municipal bond bank agency and secured by its pledge of tax revenues pursuant to the authority of section twenty-four hundred thirty-six-b of the public authorities law remain outstanding**.[45]

Municipal Bankruptcies

In the event a Municipality files for relief under Chapter 9 of the Bankruptcy Code to discharge its public pension obligations, it is very possible that a federal bankruptcy court will allow the Municipality to discharge a portion of its public pension obligations, even in the face of State constitutional prohibitions precluding impairment or diminishment of pension benefits.

Thus, while New York has authorized its Municipalities to file for Chapter 9 bankruptcy relief, this right is conditioned upon a Municipality's certification that it has no outstanding ARRA bond debt. The statute does not appear to have been challenged to date, so it is unclear whether a court would ultimately find that the law is a valid exercise of the state's sovereign right to dictate when its Municipalities may seek Chapter 9 bankruptcy relief or, alternatively, whether the law is preempted by federal bankruptcy law as violating the Bankruptcy Code's objective of creating a level playing field for all creditors. Ultimately, New York's municipal bankruptcy statute may serve as a model for an amendment to other State bankruptcy authorization statutes. Using Arizona's bankruptcy authorization statute as an example, such an amendment could provide as follows **(with material omitted reflected as ~~double strikeouts~~ and material added reflected by double underline):**

> Any taxing district or municipality in this state is authorized to file the petition provided for in the federal bankruptcy statute and to incur and pay the expenses thereof and any and all other expenses necessary or incidental to the consummation of the plan of readjustment contemplated in such petition or as it may be modified from time to time. Notwithstanding the foregoing, no taxing district or municipality is authorized to file a petition authorized by this section if the taxing district or municipality has any unfunded liability to any state or municipal public retirement plan or system.

This type of amendment would appear to comport with the purposes of federal bankruptcy law in that it gives Municipalities access to the totality of the Bankruptcy Code's rights and protections but is not an attempt by the state, once bankruptcy is filed, to "cherry pick" those provisions of Chapter 9 that it deems favorable. Rather, the amendment would simply render any Municipality with unfunded liability to a public pension plan ineligible to file for bankruptcy in the first place.

Conclusion

In the event a Municipality files for relief under Chapter 9 of the Bankruptcy Code to discharge its public pension obligations, it is very possible that a federal bankruptcy court will allow the Municipality to discharge a portion of its public pension obligations, even in the face of State constitutional prohibitions precluding impairment or diminishment of pension benefits. To avoid such a result, public pension systems need to be proactive to prevent Municipalities from discharging their pension obligations. They can do this by amending their applicable bankruptcy authorization statutes to preclude Municipalities from filing bankruptcy to discharge their pension obligations. This is the best method of ensuring that public retirement systems continue to receive all contributions required to fund their members' pensions.

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ENDNOTES

[1]Eight cities, towns or counties have filed for bankruptcy since 2010: Detroit, Michigan, San Bernadino, California, Mammoth Lakes, California, Stockton, California, Jefferson County, Alabama, Harrisburg, Pennsylvania, Central Falls, Rhode Island, and Boise County, Idaho. *See* Brad Plumer, *Detroit Isn't Alone*, Washington Post, July 18, 2013 (http://www.washingtonpost.com/blogs/wonkblog/wp/2013/07/18/detroit-isn't-alone).

[2]While Art. I, § 8, cl. 4 of the United States Constitution states that "Congress shall have the power... to establish... uniform laws on the subject of bankruptcies throughout the United States...," the 10th and 11th Amendments to the Constitution (which place certain limits upon the federal government's recourse against the States) preclude the federal government from supervising the bankruptcy of a State. *See* J. Spiotto, *Primer on Municipal Debt Adjustment* (2012) ("Primer"), at 3.