

ARTICLE

BONDHOLDERS VS. RETIREES IN MUNICIPAL BANKRUPTCIES:  
THE POLITICAL ECONOMY OF CHAPTER 9

BY

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ABSTRACT

*Financially distressed U.S. municipalities may be eligible for federal bankruptcy protection under Chapter 9 of the Bankruptcy Code. These municipal debtors tend to be burdened by the claims of two large classes of creditors: bondholders, on the one hand, and retirement benefit recipients, on the other. In recent high-profile Chapter 9 cases, U.S. Bankruptcy Courts have clarified the legal rights and entitlements of these two creditor classes, paving the way for municipal debtors to use bankruptcy to restructure both bond and pension obligations in times of scarcity.*

*Notwithstanding these judicial pronouncements, the municipalities in these and other cases have mostly declined to modify their public pensions, instead advancing plans of adjustment that privilege pension claimants over all other constituents. In public discourse, these outcomes are celebrated as triumphs of an employee-centric application of principles of fairness and equity.*

*But case dockets tell a different story. This Article constructs detailed case studies to challenge the assumption that employee-centric principles of fairness and equity are driving case outcomes. Rather, the political economy of Chapter 9 has enabled large and prominent pension administrators to exert more power and influence over restructurings. And it is not clear that these outcomes actually serve employees' and retirees' broader economic interests. Reforms are needed to enhance the fairness and efficiency of Chapter 9, and to more effectively advance important public policy goals.*

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## INTRODUCTION

Like businesses and individuals, U.S. municipalities may seek federal bankruptcy protection when they become financially distressed. For instance, in 2012, when the iconic Eastman Kodak Company filed for bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York because of declining revenues and product obsolescence,<sup>1</sup> the beleaguered City of Stockton, California sought relief from escalating pension costs and bond debts in the U.S. Bankruptcy Court for the Eastern District of California.<sup>2</sup> And in 2013, when the accused and acquitted Casey Anthony filed for bankruptcy protection in the U.S. Bankruptcy Court for the Middle District of Florida to escape fees associated with her legal defense,<sup>3</sup> the troubled City of Detroit also petitioned for relief in the U.S. Bankruptcy Court for the Eastern District of Michigan to stem its own downward spiral.<sup>4</sup> In each case, the narrative is essentially the same: the bankrupt claims to be unable to satisfy all obligations, and agrees to be subject to the jurisdiction of the court to obtain a much-needed fresh start.<sup>5</sup>

But while there are similarities among individual, business, and municipal bankruptcies, there are also important differences in the legal frameworks that apply to individual and business debtors,<sup>6</sup> on the one hand, and that which governs municipal debtors, on the other. For one thing, individual debtors are—depending on their financial circumstances<sup>7</sup>—permitted to file under Chapter 7,<sup>8</sup> Chapter 11,<sup>9</sup> or

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<sup>1</sup> Voluntary Petition of Eastman Kodak Co., *In re Eastman Kodak Co.*, Case No. 12-10202 (ALG) (Bankr. S.D.N.Y. Jan. 19, 2012).

<sup>2</sup> Voluntary Petition of City of Stockton, California, *In re City of Stockton, California*, Case No. 12-32118 (Bankr. E.D.Cal. June 28, 2012).

<sup>3</sup> Voluntary Petition of Casey Marie Anthony, *In re Casey Marie Anthony*, Case No. 13-00922 (Bankr. M.D.Fla. Jan. 25, 2013).

<sup>4</sup> Voluntary Petition of City of Detroit, *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D.Mich., July 18, 2013).

<sup>5</sup> On the centrality of the “fresh start” concept in bankruptcy law and policy, *see, e.g.*, Thomas H. Jackson, *The Fresh Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985).

<sup>66</sup> The person who is the subject of a bankruptcy case is referred to as the “debtor.” 11 U.S.C. §101.

<sup>7</sup> Chapter 7 debtors with primarily consumer debts are subject to dismissal for abuse based on a presumptive “means test.” *See* 11 U.S.C. §707(b)(2).

<sup>8</sup> 11 U.S.C. §§ 701–784 (providing for liquidations of bankrupt persons).

<sup>9</sup> 11 U.S.C. §§ 1101–1174 (providing for reorganizations and liquidations of bankrupt persons).

Chapter 13<sup>10</sup> of the U.S. Bankruptcy Code.<sup>11</sup> Business debtors file under Chapter 7 or Chapter 11. In contrast, **municipal debtors are *only* permitted to file under Chapter 9,**<sup>12</sup> a portion of the Bankruptcy Code devoted exclusively to the reorganization of municipalities, villages, counties, taxing districts, municipal utilities, and school districts.<sup>13</sup> And, in stark contrast to the relief provided to individual and business debtors under Chapter 7, **Chapter 9 offers no mechanism for liquidating the debtor’s assets and distributing proceeds to creditors.** Instead, debtors must develop and gain judicial confirmation of a plan to restructure obligations.<sup>14</sup> Chapter 9 is the only chapter of the Bankruptcy Code that requires debtors to be “insolvent,” meaning for these purposes that the municipality is unable to satisfy obligations as they come due.<sup>15</sup>

**Municipal bankruptcies are also unique in that debtors tend to be burdened by the claims of two specific, large classes of creditors: bondholders, on the one hand, and retirement benefit recipients, on the other.** This is not to say, of course, that municipal debtors do not experience other types of claims, such as those filed by vendors, contractors, traditional bank lenders, and judgment creditors. **It’s just that the lion’s share of the debt tends to be bond and pension obligations;** and in times of municipal financial distress, restructuring discussions quickly devolve into a battle between bondholders and retirees over the municipality’s scarce resources.

In many cases, bankruptcy law ranks these two classes of claims side by side. Indeed, if there was ever any doubt, recent high-profile judicial opinions have clarified that *both* obligations may be adjusted in bankruptcy, regardless of state laws that make one or the other seem inviolate. But a string of recent, large Chapter 9 cases has featured negotiated settlements and cramdowns that fully preserve public pensions at the expense of other stakeholders. These outcomes suggest what most

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<sup>10</sup> 11 U.S.C. §§ 1301–1330 (providing for adjustments of debts of individuals).

<sup>11</sup> All references herein to the “Bankruptcy Code” or the “Code” are to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101 et. seq.).

<sup>12</sup> 11 U.S.C. §§ 901–946.

<sup>13</sup> The definition of “municipality” is explored in Michael J. Deitch, *Time for an Update: A New Framework for Evaluating Chapter 9 Bankruptcies*, 83 FORDHAM L. REV. 2705 (2015).

<sup>14</sup> Plan confirmation requirements are set forth in 11 U.S.C. §943(b).

<sup>15</sup> See *infra* note 42.

economists would already acknowledge: legal rights do not tell the whole story.<sup>16</sup>

The public discourse surrounding recent large municipal bankruptcies mostly celebrates these case outcomes as triumphs of an employee-centric application of principles of fairness and equity. In other words, large municipal bankruptcies present a moral conflict between the duty to honor contractual debt obligations, on the one hand, and the covenant to deliver promised deferred compensation to employees, on the other. And most people believe that the latter has a higher moral claim to payment.<sup>17</sup> Acknowledging this phenomenon, Professors Richard Hynes and Steven Walt observed that “Many believe that fairness requires that the law should grant retirees priority over bondholders, either because they need the money more or because bondholders can more easily bear the risk of non-payment.”<sup>18</sup> For instance, a *Los Angeles Times* reporter opined, “this is less a legal argument than a moral one, but it’s good [when] retirees suffer relatively light pain compared with the bondholders and other creditors.”<sup>19</sup> In a similar way, a political commentator for *Michigan Radio* intimated that retirement benefit recipients are more deserving of protection than financial institution creditors because “[w]hen poor people have money, they don’t put it in offshore banks. They tend to spend it on necessities in their neighborhoods.”<sup>20</sup> And a former New York City politician explained that “there is in fact a measurable distinction between the economic security of pensioners who live hand-to-mouth and bondholders,” such that “low and moderate income pensioners have a higher moral claim to protection...than do bondholders.”<sup>21</sup> Expounding on these arguments, Professor Jack Beermann has contributed thoughtful scholarship highlighting the vulnerable economic position of many public pension claimants, who have performed their employment duties in exchange not

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<sup>16</sup> Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

<sup>17</sup> See, e.g., *infra* notes 18 through 21; see also Donald C. Carroll, *The National Pension Crisis: A Test in Law, Economics, and Morality*, 50 U.S.F. L. REV. 469 (2016) (eloquently exploring the intersections of moral claims, legal arguments, and economic policy).

<sup>18</sup> Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 REV. OF BANKING & FIN. L. 609, 612 (2014).

<sup>19</sup> Scott Martelle, *Opinion: Detroit bankruptcy ruling good for retirees, but city has long way to go*, L.A.TIMES, Nov. 7, 2014.

<sup>20</sup> Jack Lessenberry, *Pension cuts in Detroit’s bankruptcy plan would be devastating and unfair*, MICHIGANRADIO.COM, Feb. 24, 2004.

<sup>21</sup> Richard Brodsky, *Detroit and Wall Street: The Moral Conflict Between Pensioners and Bankers*, HUFFINGTONPOST.COM, Aug. 15, 2013.

only for a paycheck, but also in consideration of the promise that their post-retirement financial needs will be met.<sup>22</sup>

But not everyone agrees that these moral and equitable arguments should drive restructuring outcomes to the point of severely impairing the rights of other claimants. Professor Frank Shafroth acknowledged that there may be compelling reasons to favor retirees over bondholders, but argued that the latter should not be cast aside so quickly; after all, municipal bond investors “are critical to a municipality’s future and its ability to raise money to build and modernize infrastructure and services.”<sup>23</sup> Meanwhile, a *Reuters* journalist reminded readers that preserving pensions at the expense of bondholders could “make capital market lenders more wary about loaning money to struggling cities, and could increase borrowing costs for cities already in debt.”<sup>24</sup> Indeed, practical concerns of this sort were enough to motivate cities to repay their capital market creditors for nearly a century: from the 1930s until 2012, large municipalities in bankruptcy always fully repaid principal owed to bondholders.<sup>25</sup> Even the ailing city of Vallejo, California, promised to honor its pension obligations *and* repay bondholders in full when it emerged from bankruptcy in 2011.<sup>26</sup>

Everything changed when, in 2012, the California city of San Bernardino filed for bankruptcy, proposing and ultimately gaining confirmation of a restructuring plan that paid pension obligations in full while slashing bond debt. Many commentators celebrated the restructuring for its righteous treatment of pension benefit recipients. Several other large cities followed suit, leading to the emergence of a new prototype for municipal bankruptcy restructuring of so-called “structurally impaired”<sup>27</sup> cities. First, as budgetary pressures mount, the distressed municipality imposes steep reductions on its current workforce, in the form of layoffs,

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<sup>22</sup> Jack M. Beerman, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3 (2013)

<sup>23</sup> Frank Shafroth, *Municipal Bondholders Beware*, GOVERNING.COM, Sept. 2015.

<sup>24</sup> Tim Reid, *San Bernardino bankruptcy plan: bondholders hammered while pensions kept whole*, REUTERS, May 14, 2015.

<sup>25</sup> Steven Church, *Stockton Threatens to be First City to Stiff Bondholders*, BLOOMBERG, June 29, 2012.

<sup>26</sup> See generally Alison Vekshin & Martin Z. Braun, *Vallejo’s Bankruptcy ‘Failure’ Scars Cities Into Cutting Costs*, BLOOMBERG, Dec. 13, 2010.

<sup>27</sup> The term is used to distinguish cities like Detroit, which suffered longstanding structural budgetary imbalances, from cities that pursued bankruptcy because of a one-time event that renders them insolvent. See Deitch, *supra* note 13, at 2728-2734.

furloughs, and other pay and benefits reductions.<sup>28</sup> If financial distress worsens, the city may default on bond payments and/or annual pension obligations and turn to Chapter 9 for protection. Once in bankruptcy, the city sheds bond debt and terminates ancillary employee or retiree benefits—such as health care insurance—while leaving existing pension benefits fully intact or only slightly reduced. Finally, upon reemerging from bankruptcy, the city raises taxes and/or slashes future labor costs, either by reworking pension programs entirely so that future benefits are reduced or eliminated,<sup>29</sup> or by outsourcing jobs to reduce the percentage of future workers eligible for retirement benefits.

This Article chronicles the rise of the prototypical municipal bankruptcy restructuring in recent large Chapter 9 cases, using detailed case studies to look beyond the moral explanation and evaluate the complicated dynamics that may cause debtors to privilege public pension claimants over other stakeholders. It proceeds as follows. Part I provides a brief overview of Chapter 9 bankruptcy and the legal classifications of bondholder and retiree claims. Part II presents detailed case studies of three recent, large municipal bankruptcies, paying particular attention to the ways in which powerful actors pressed toward settlements. Part III presents a thoughtful critique, arguing that the emerging prototypical municipal bankruptcy restructuring reflects the political economy of Chapter 9 rather than strict adherence to a moral or equitable framework. This Part also argues that a balanced and thoughtful legal framework, with a built-in safe harbor that addresses important social policy concerns, may ultimately provide fairer and more efficient outcomes in Chapter 9 municipal bankruptcy cases. Part IV concludes.

#### I. BACKGROUND: THE TREATMENT OF BONDS AND PENSIONS IN CHAPTER 9 BANKRUPTCY

This Part introduces the basic laws governing municipal bankruptcy, and also describes the types of creditors that typically dominate Chapter 9

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<sup>28</sup> Bankruptcy attorney Richard Trotter explains that “workforce reduction through furloughs, hiring freezes and layoffs” is quite common: “One in seven cities has already made cuts to public safety services such as police, fire and emergency.” Richard W. Trotter, *Running on Empty: Municipal Insolvency and Rejection of Collective Bargaining Agreements in Chapter 9 Bankruptcy*, 36 S. ILL. U. L.J. 45, 48 (2011).

<sup>29</sup> See Mary Williams Walsh, *Detroit Rolls Out New Model: A Hybrid Pension Plan*, N.Y. TIMES, June 18, 2014.

restructuring negotiations: bondholders and retirement benefit recipients.<sup>30</sup> It is important to note that the discussion below sets aside the moral framework, analyzing substantive and procedural matters strictly under applicable bankruptcy and other debtor-creditor laws.

#### A. AN INTRODUCTION TO CHAPTER 9 BANKRUPTCY

Although municipalities suffer many of the same financial challenges that individuals and businesses experience, their access to federal bankruptcy protection follows a different path, meandering around thorny questions of federalism and constitutional law. On the one hand, the U.S. Constitution reminds states of the limited power they have to impair contracts, including a municipality's debt arrangements,<sup>31</sup> authorizing only Congress to enact "uniform Laws on the subject of Bankruptcies throughout the United States."<sup>32</sup> On the other hand, although the federal government may establish laws governing bankruptcies—including municipal bankruptcies—it must not run afoul of the Tenth Amendment. Thus, federal bankruptcy law respects states' sovereign powers over internal affairs, including property, revenue, and fiscal matters.<sup>33</sup>

In light of these federalism concerns, the drafters of the Bankruptcy Code established an entirely separate statutory chapter—Chapter 9—to govern municipal bankruptcies.<sup>34</sup> Only a "municipality" may petition for relief under its provisions.<sup>35</sup> The term "municipality" includes any "political subdivision or public agency or instrumentality of a State."<sup>36</sup> For instance, counties, cities, towns, villages, and townships, as well as special

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<sup>30</sup> For a penetrating look at the battle between these two stakeholders in the bankruptcy restructuring of the City of Central Falls, Rhode Island, see Maria O'Brian Hylton, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525 (2014).

<sup>31</sup> U.S. CONST. art. I, §10, cl. 1 ("No State shall...pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts.")

<sup>32</sup> U.S. CONST. art. I, §8, cl. 4.

<sup>33</sup> See U.S. CONST. amend. X ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.") The constitutional balance in municipal bankruptcy was explored in *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513 (1936).

<sup>34</sup> For a penetrating discussion of the development of U.S. municipal bankruptcy law, see Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403 (2014).

<sup>35</sup> 11 U.S.C. §109(c).

<sup>36</sup> 11 U.S.C. §101(40).

purpose public entities organized to construct, maintain, and operate revenue-producing enterprises, are eligible to file.<sup>37</sup>

While the Bankruptcy Code establishes a process for municipal bankruptcy, only states may authorize their municipalities to take advantage of the opportunity.<sup>38</sup> In this way, the Bankruptcy Code acknowledges that states have the sovereign power to “act as gatekeepers to their municipalities’ access to relief.”<sup>39</sup> Some states outright prohibit municipalities from availing themselves of Chapter 9 protection;<sup>40</sup> others provide express and unconditional or express but qualified authorization. For instance, California permits municipalities to file for bankruptcy following completion of mandatory mediation.<sup>41</sup> In states that have no explicit laws on the books, municipalities seeking Chapter 9 protection must petition the state legislature to pass a new law authorizing the filing.

After receiving state authorization to file, a municipality must meet three eligibility requirements for Chapter 9 bankruptcy. First, it must be “insolvent.”<sup>42</sup> Although the Bankruptcy Code typically uses a balance sheet test to determine whether individual or business debtors are insolvent, municipal assets are not so easily valued; moreover, asset values are less relevant for debtors that cannot be liquidated. Therefore, Chapter 9 is unique in that it uses a cash flow test for insolvency.<sup>43</sup> To satisfy the test, a municipality must demonstrate that it is unable to or generally not paying debts as they become due.<sup>44</sup> Even though municipal cash flow is largely dependent on taxation, the debtor is not required to make a showing that it has attempted to raise taxes in order to satisfy its obligations.<sup>45</sup> Critical of this aspect of the extant legal framework, Professor John Hunt recently argued that, absent extenuating circumstances, bankruptcy courts

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<sup>37</sup> See, e.g., *In re* County of Orange, 183 B.R. 594 (Bankr. C.D.Cal. 1995) (discussing eligibility requirements); *In re* Las Vegas Monorail Co., 429 B.R. 770 (Bankr. D. Nev. 2010).

<sup>38</sup> 11 U.S.C. §109(c)(2).

<sup>39</sup> *In re* City of Vallejo, 403 B.R. 72, 76 (Bankr. E.D.Cal. 2009).

<sup>40</sup> See, e.g., Iowa Code Ann. 76 16 (2015).

<sup>41</sup> See, e.g., Cal. Gov’t Code §53760.

<sup>42</sup> 11 U.S.C. §109(c)(3). “Insolvent” is defined in 11 U.S.C. §101(32)(C). For municipalities, insolvency is primarily determined pursuant to a cash flow analysis, rather than a balance sheet analysis. *In re* City of Bridgeport, 129 B.R. 332, 337 (D.Conn. 1991).

<sup>43</sup> See *In re* City of Bridgeport, 129 B.R. 322 (Bankr. D. Conn. 1991).

<sup>44</sup> 11 U.S.C. §101(32)(c)(i)-(ii).

<sup>45</sup> See *In re* City of Bridgeport, 129 B.R. 322 (Bankr. D. Conn. 1991).



should require that a municipality tax at the top of its peer group as a condition precedent to seeking bankruptcy protection.<sup>46</sup>

Second, a municipality seeking Chapter 9 protection must “desire[] to effect a plan to adjust [its] debts.”<sup>47</sup> This is essentially a “filing in good faith” requirement, meaning that the municipality must not be using bankruptcy merely to “buy time or evade creditors.”<sup>48</sup> This prong is further reinforced by Section 921 of the Bankruptcy Code, which authorizes “the court, after notice and a hearing, [to] dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the requirements of this title.”<sup>49</sup> In making the determination, courts typically look at evidence concerning the debtor’s subjective beliefs and motivations, and whether Chapter 9 is likely to offer relief.

Finally, a municipality seeking Chapter 9 protection must make a showing that it has negotiated in good faith with its creditors or that such negotiations would be futile.<sup>50</sup> To satisfy the standard, courts typically require that debtors engage in genuine and meaningful negotiations, rather than mere “take-it-or-leave-it proposal[s]” in which “substantive terms... were not open to discussion.”<sup>51</sup>

The process through which a municipal debtor seeks to demonstrate eligibility for Chapter 9 bankruptcy can be lengthy. As the influential U.S. Bankruptcy Court for the Southern District of New York explained, municipal bankruptcy petitions should be looked upon “with a jaded eye.”<sup>52</sup> Another court characterized the eligibility process as an “intentionally difficult task.”<sup>53</sup> This is because, once the petition is approved and the municipal debtor is permitted to enter bankruptcy, the debtor enjoys the benefit of the breathing room afforded by the automatic stay,<sup>54</sup> but the court has “severely limited control over the debtor.”<sup>55</sup>

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<sup>46</sup> John Patrick Hunt, *Taxes and Ability to Pay in Municipal Bankruptcy*, 91 WASH. L. REV. 515 (2016).

<sup>47</sup> 11 U.S.C. §109(c)(4).

<sup>48</sup> David G. Heiman, et. al., *An Overview of Chapter 9 of the Bankruptcy Code: Municipal Debt Adjustments*, JonesDay.com, August 2010.

<sup>49</sup> 11 U.S.C. §921(c).

<sup>50</sup> 11 U.S.C. §901(c)(5).

<sup>51</sup> *In re Ellicott Sch. Bldg. Auth.*, 150 B.R. 261, 266 (Bankr. D. Colo. 1992).

<sup>52</sup> *In re N.Y.C. Off-Track Betting Corp.*, 427 B.R. 256, 264 (Bankr. S.D.N.Y. 2010).

<sup>53</sup> *In re Sullivan County Reg’l Refuse Disposal Dist.*, 165 B.R. 60, 82 (Bankr. D.N.H. 1994).

<sup>54</sup> 11 U.S.C. §362.

<sup>55</sup> *In re Sullivan County Reg’l Refuse Disposal Dist.*, 165 B.R. 60, 82 (Bankr. D.N.H. 1994).

Once it is deemed eligible for Chapter 9 bankruptcy, a municipal debtor works to achieve consensus among creditors and gain judicial confirmation of a plan to restructure its obligations.<sup>56</sup> The U.S. Trustee may appoint one or more official committees to represent the interests of creditors holding similar classes of claims.<sup>57</sup> In the typical municipal bankruptcy, an official retiree committee is formed; an unsecured creditors committee may also be created.<sup>58</sup>

The debtor's proposed plan of adjustment must meet some baseline statutory confirmation requirements, including requirements that are also imposed on Chapter 11 debtors: for instance, the plan must have been proposed in "good faith."<sup>59</sup> In some respects, Chapter 9 is similar to other chapters of the Bankruptcy Code in that it allows debtors to restructure their finances by modifying the terms of their debt instruments and/or refinancing existing obligations by entering into new financial arrangements. At the same time, Chapter 9 is distinguishable from other portions of the Bankruptcy Code in that it does not permit the court to order liquidation.<sup>60</sup> This is because a municipality provides basic and essential services to the public; moreover, federal court-ordered liquidation of a municipality would clearly run afoul of the state's sovereign powers.<sup>61</sup>

Similarly, as other scholars have acknowledged, Chapter 9 debtors have substantially more autonomy than business or individual debtors filing under other chapters of the Bankruptcy Code.<sup>62</sup> This is because Chapter 9 necessarily contains special limitations on the powers of the

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<sup>56</sup> Plan confirmation requirements are set forth in 11 U.S.C. §943(b).

<sup>57</sup> Authorization for committee appointment is provided under 11 U.S.C. §1102.

<sup>58</sup> The formation of an unsecured creditors committee is not considered to be mandatory in a Chapter 9 case. *See* Order Granting the City's Motion to Vacate the Appointment of the Official Committee of Unsecured Creditors, *In re* City of Detroit, Case No. 13-53846 (Bankr. E.D. Mich. Feb. 28, 2014); Order Denying Motion to Appoint Committee of Creditors With Claims Under 42 U.S.C. § 1983, *In re* City of Detroit, Case No. 13-53846 (Bankr. E.D. Mich. Mar. 11, 2014).

<sup>59</sup> 11 U.S.C. §901(a) (imposing the requirements of 11 U.S.C. §1129(a)(3)).

<sup>60</sup> *See, e.g.*, Eric Scorsone & Nicolette Bateson, *Evaluating a Chapter 9 Bankruptcy for City of Detroit: Reality Check or Turnaround Solution?*, Dept. of Agricultural, Food and Resource Economics, Michigan State Univ., Staff Paper 2012-01, at 22.

<sup>61</sup> *Id.*

<sup>62</sup> *See, e.g.*, Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281 (2012); Michael W. McConnell & Randall C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425 (1993).

court.<sup>63</sup> Here again, the law maintains a delicate constitutional balance between federal authority and state sovereignty: “Principles of dual sovereignty, deeply embedded in the fabric of this nation and commemorated in the Tenth Amendment...severely curtail the power of bankruptcy courts to compel municipalities to act once a petition is approved.”<sup>64</sup> Accordingly, the powers of the bankruptcy court must yield to the state’s sovereign right to control the exercise of “political or governmental powers” of a municipality.<sup>65</sup> This means that the bankruptcy court cannot compel the debtor to continue to pay certain obligations during the pendency of the case.<sup>66</sup> Instead, the Chapter 9 debtor “retains title to, possession of, and complete control over its property and its operations, and is not restricted in its ability to sell, use, or lease its property.”<sup>67</sup> Unfortunately, as Professors Clayton Gillette and David Skeel recently observed, these limitations on the powers of the bankruptcy court leave federal bankruptcy process fundamentally ill-equipped to address the underlying governance dysfunction that often leads to municipal financial distress.<sup>68</sup> The following sections examine some of the most common types of claims held by creditors of bankrupt municipalities.

#### B. CREDITOR CLAIMS IN MUNICIPAL BANKRUPTCY

Most debtors—municipal or otherwise—seek federal bankruptcy protection to gain breathing room from creditors and restructure their obligations. Throughout the Bankruptcy Code, the persons to whom a debtor owes obligations are referred to as “creditors”<sup>69</sup> holding “claims”<sup>70</sup> against the debtor.<sup>71</sup> Claims may be secured by a lien on real or personal property, or they may be unsecured. Claims are also prioritized under the

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<sup>63</sup> See 11 U.S.C. §903-904.

<sup>64</sup> *In re* N.Y.C. Off-Track Betting Corp., 427 B.R. 256, 264 (Bankr. S.D.N.Y. 2010).

<sup>65</sup> 11 U.S.C. §903 & 904.

<sup>66</sup> See, e.g., *In re* City of Stockton, 478 B.R. 8 (Bankr. E.D. Cal. 2012) (acknowledging the court’s inability to compel the Debtor’s continued payment of retiree health benefits during the Chapter 9 case).

<sup>67</sup> *In re* Valley Health System, 429 B.R. 692, 714 (Bankr. C.D. Cal. 2010).

<sup>68</sup> Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L.J. 1150 (2016).

<sup>69</sup> 11 U.S.C. §101(10).

<sup>70</sup> 11 U.S.C. §101(5).

<sup>71</sup> Under other chapters of the Bankruptcy Code, these claims are against the debtor’s “estate” under 11 U.S.C. §541(a). But in Chapter 9, “property of the estate” means property of the debtor. 11 U.S.C. §902(1).

Bankruptcy Code based on the nature of the underlying obligation.<sup>72</sup> Although municipal bankruptcies typically feature a wide range of claims, such as obligations owed to vendors, contractors, and employees, most of the large, recent Chapter 9 cases have revolved around two dominant classes of claims: municipal bond debt and public pension obligations. The following subsections introduce these forms of indebtedness and their classifications under bankruptcy law.

#### 1. MUNICIPAL BONDS

Like most bankrupt persons, municipal debtors in Chapter 9 have typically engaged in large amounts of borrowing to finance improvements and other expenditures. But municipal indebtedness has some distinct features. For one thing, rather than approaching banks for so-called direct loans, municipalities have traditionally turned to a highly specialized corner of the capital markets by selling debt securities known as municipal bonds.<sup>73</sup> With some exceptions, municipal bonds are exempt from federal income taxation,<sup>74</sup> making them a popular fixed income financial asset. They are also generally perceived as stable investments, “provid[ing] a haven for investors during sharp swings...in the equity and high-yield corporate-bond markets.”<sup>75</sup> The U.S. Securities and Exchange Commission recently estimated the size of the municipal bond market to be approximately \$2.8 trillion.<sup>76</sup>

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<sup>72</sup> 11 U.S.C. §507.

<sup>73</sup> See, e.g., Randle B. Pollard, *Feeling Insecure—A State View of Whether Investors in Municipal General Obligation Bonds Have a Mere Promise to Pay or a Binding Obligation*, 24 WIDENER L. REV. 19, 22 (2015). However, the municipal borrowing market is evolving, as municipalities increasingly engage in direct borrowing from individual banks to finance or refinance improvements. See Ianthe Jeanne Dugan, *Banks Go Straight to Public Borrowers*, WALL ST.J., Feb. 16, 2011.

<sup>74</sup> 26 U.S.C. §103(a). The income tax exemption does not apply to municipal bonds that are used for private, non-governmental uses, or that are used by the issuer to invest in higher-yielding securities. *Id.* at §103(b)(1)-(2). Moreover, taxpayers who are subject to the alternative minimum tax would not enjoy the benefit of the exemption. 26 U.S.C. §§55-59.

<sup>75</sup> Heather Gillers & Aaron Kuriloff, *Latest Hot Buy: Municipal Bonds*, WALL ST.J., June 6, 2016.

<sup>76</sup> See Fast Answers, Municipal Bonds, at <https://www.sec.gov/answers/bondmun.htm>.

There are various types of municipal bond instruments,<sup>77</sup> which are governed by an intricate overlay of federal, state, and local laws. Thus it is impossible to provide a summary that captures all of the legal nuances of such a diverse asset class.<sup>78</sup> Nonetheless, some generalizations are possible, and they provide helpful background for the case studies that follow.

The two basic types of municipal bonds are general obligation bonds, which are backed by the municipality's pledge of its full faith and credit and/or taxing powers,<sup>79</sup> and revenue bonds,<sup>80</sup> which are typically secured by pledges of specific revenues, such as proceeds derived from operation of a facility financed by the bond issue. It is important to further distinguish between general obligation bonds and general fund securities.<sup>81</sup> Professor Randle Pollard explained, "General obligation bonds are secured by a pledge of taxes; levy and collection of *ad valorem* taxes or state legislature appropriations. General securities are simply payable from a state or local government's general fund."<sup>82</sup> Thus, while general securities are essentially mere promises to repay indebtedness, general obligation bonds—much like revenue bonds—enjoy special credit enhancements. In the case of general obligation bonds, the debt securities are enhanced by the full faith and credit of the issuer. This means that the municipality pledges to use all available resources to repay bondholders, including its taxing powers and future borrowing capacity. In the case of revenue bonds, the debt securities are protected by specific revenue streams, typically generated by the project financed by the bonds.

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<sup>77</sup> For a discussion of the various types of municipal bonds, see Pollard, *supra* note 73.

<sup>78</sup> A similar cautionary note was made by the prominent bond attorneys who authored *GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY AND DISCLOSURE CONSIDERATIONS*, NAT'L ASSOC. OF BOND LAWYERS, Aug. 2014.

<sup>79</sup> A New York court famously explained the power of full faith and credit: "an obligation containing a pledge of the city's 'faith and credit' is secured by a promise both to pay and to use in good faith the city's general revenue powers to produce sufficient funds to pay the principal and interest of the obligation as it becomes due." *Flushing Nat'l. Bank v. Mun. Assistance Corp. for New York*, 358 N.E.2d 848, 851 (N.Y. 1976).

<sup>80</sup> This category is acknowledged and defined in for the purposes of the Bankruptcy Code in 11 U.S.C. §902(2).

<sup>81</sup> *GENERAL OBLIGATION BONDS*, *supra* note 78, at 24-26.

<sup>82</sup> *Id.* at 25.

Finally, municipalities increasingly issue so-called “pension obligation bonds.”<sup>83</sup> Pension obligation bonds are a special form of taxable municipal bonds issued by governmental entities to finance their annual obligations to employee pension funds.<sup>84</sup> When municipalities engage in this form of borrowing, they are essentially betting that the money they borrow against future tax revenues will earn a higher return once invested by the pension fund, not only beating the lower rate of interest owed to bondholders but also potentially reducing the issuer’s future annual payments to the pension fund.

In each case, a municipality’s pledge to apply all or some of its resources to repay bond debt is often viewed outside of bankruptcy as the functional equivalent of a lien on future revenues. But as Professor David Skeel has explained,<sup>85</sup> absent some other grant of security in the debtor’s real or personal property, bankruptcy law treats only revenue bonds as secured claims; general obligation bonds are classified as general unsecured claims.<sup>86</sup> This is because, under the Bankruptcy Code, municipal bonds are considered “secured” by future revenues solely to the extent that the issuer has effectively granted a lien on certain designated “special revenues.”<sup>87</sup> As a result, in the event of a municipal bankruptcy, most municipal bondholders—other than those holding revenue bonds or those with liens on the debtor’s real or personal property—are classified as general creditors holding unsecured claims.

## 2. PUBLIC PENSIONS

In addition to the usual claims by current employees for wages and benefits, municipal debtors also typically confront claims of retired employees who are owed deferred compensation and other promised benefits. The public pension market is substantial; one journalist recently observed, “[n]early 80% of state and local government employees are

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<sup>83</sup> This particular debt security is considered in Eric Schulzke, *Pension Obligation Bonds: Risky Gimmick or Smart Investment?*, GOVERNING, Jan. 2013.

<sup>84</sup> See generally Marilyn Cohen, *Beware of Pension Obligation Bonds*, FORBES, Jan. 5, 2016.

<sup>85</sup> David A. Skeel, *What is a Lien? Lessons From Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675.

<sup>86</sup> David Skeel, *The Education of Detroit’s Pension and Bond Creditors*, 2 PENN WHARTON PUB. POL’Y INITIATIVE 1, 3 (2014), available at <http://publicpolicy.wharton.upenn.edu/live/files/166-a>.

<sup>87</sup> 11 U.S.C. §928; see also 11 U.S.C. §902 (defining “special revenues”).

covered by a defined-benefit plan.”<sup>88</sup> These defined benefit plans provide retirees with fixed, predetermined payments calculated in reference to each participant’s total years of service and salary.

In contrast, most *private* sector retirement plans are so-called “defined contribution” plans, such as 401ks. Although defined benefit plans exist in the private sector, there are important distinctions between public sector pensions and their private sector counterparts. As one study observed, “Public defined benefit plans tend to provide larger benefits than their private sector counterparts, and most offer post-retirement cost-of-living adjustments, which are virtually unheard of in the private sector.”<sup>89</sup> Moreover, private pension benefits are insured by the Pension Benefit Guaranty Corporation, a governmental entity that collects premiums from private pension plan sponsors and pays benefits—up to a certain amount—to retirees of failed pension plans.<sup>90</sup> Public pensions are not covered under this program.<sup>91</sup> However, in an effort to better manage these obligations, many municipalities have shifted to third-party management by professional administrators—such as the California Public Employees’ Retirement System (“CalPERS”),<sup>92</sup> the large and prominent administrator of most California public pensions—to hold plan assets and monitor investments based on actuarial analyses. Under the typical third-party pension management contractual arrangement, municipalities (as “plan sponsors”) are required to make annual contributions that are calculated by the administrator to maintain or improve the ratio between funded and unfunded liabilities.

Notwithstanding the requirement of annual contributions, the combination of more generous benefits, on the one hand, and the lack of insurance protection from plan failure, on the other, means that public pensions have the potential to be far riskier than their private sector counterparts. At least in theory, plan sponsors and beneficiaries share the

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<sup>88</sup> Sandra Block, *The Problem With Public Pensions*, Kiplinger’s PERSONAL FINANCE, Jan. 2016.

<sup>89</sup> Alicia H. Munnell & Mauricio Soto, *State and Local Pensions are Different from Private Plans*, Center for Retirement Research at Boston College, Nov. 2007.

<sup>90</sup> The program was established under 29 U.S.C. §1302.

<sup>91</sup> *Id.* The program applies only to “private” pension plans.

<sup>92</sup> CalPERS is the country’s largest government worker pension fund. On the fund’s history, see generally Steve Malanda, *The Pension Fund That Ate California: CalPERS’s corruption, insider dealing, and politicized investments have overwhelmed taxpayers with debt*, CITY JOURNAL, Winter, 2013 (alleging that the fund’s poor investment choices and mismanagement have crippled California’s public finances);

economic risk of plan failure: sponsors may need to deplete other municipal resources to honor pension claims, and beneficiaries may discover that their plan is unable to pay anticipated benefits. But in most states, statutes, judicial rulings, and state constitutional amendments have sought to reduce or eliminate the risk to beneficiaries of nonpayment by declaring it unlawful to impair public pensions.<sup>93</sup> In effect, these legal protections mean that public pension plan sponsors are obligated to provide promised benefits whether or not they have adequately funded the plan, and regardless of how plan investments have performed.

For these reasons, public pensions are famously viewed as “untouchable.”<sup>94</sup> But what is the nature of public pension liabilities in Chapter 9 bankruptcy? Federal bankruptcy process is, after all, capable of overturning a variety of state law contract *and* property rights in order to effectuate lawful restructurings.<sup>95</sup> For instance, under bankruptcy law, a city may assume or reject an executory contract, or unilaterally or consensually modify its terms.<sup>96</sup>

The question of whether municipalities are permitted to use bankruptcy to terminate or unilaterally modify pension contracts was famously addressed by the U.S. Bankruptcy Court overseeing the City of Detroit’s restructuring. In a December 2013 ruling, the court explained, “Pension benefits are a contractual right and are not entitled to any heightened protection in a municipal bankruptcy.”<sup>97</sup> Journalists for *The New York Times* characterized the court’s pronouncement as a “major blow to the widely held belief that state laws preserve public pensions, . . . likely to resonate in Chicago, Los Angeles, Philadelphia and many other American cities.”<sup>98</sup>

A similar decision was reached by the bankruptcy court overseeing the City of Stockton’s restructuring, accompanied by a written opinion that

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<sup>93</sup> The state law landscape is summarized in Liz Farmer, *How Are Pensions Protected State-by-State?*, GOVERNING, Jan. 28, 2014.

<sup>94</sup> See, e.g., Mary Williams Walsh, *Untouchable Pensions May Be Tested in California*, N.Y. TIMES, March 16, 2012.

<sup>95</sup> See *U.S. v. Bekins*, 304 U.S. 27, 54 (1938); *Ashton v. Cameron Cnty. Water Improvement Dist.*, 298 U.S. 513, 530 (1936); *Sturges v. Crowninshield*, 17 U.S.(4 Wheat.) 122, 191 (1819).

<sup>96</sup> See 11 U.S.C. §901 (making Section 365 of the Bankruptcy Code applicable to Chapter 9 cases).

<sup>97</sup> Monica Davey, Bill Vlasic & Mary Williams Walsh, *Detroit Ruling on Bankruptcy Lifts Pension Protections*, N.Y. TIMES, Dec. 3, 2013.

<sup>98</sup> *Id.*



sheds additional light on the technical nature of pension obligations in bankruptcy.<sup>99</sup> In that opinion, Judge Christopher Klein addressed “the threshold question whether, as a matter of law, pension contracts entered into by the City...may be rejected”<sup>100</sup> as an executory contract.<sup>101</sup> Answering in the affirmative, the court had strong words for CalPERS, which had relentlessly argued that the city was required to satisfy its claims in full: “[t]he bully may have an iron fist, but it also turns out to have a glass jaw.”<sup>102</sup>

In particular, the court called into question the pension administrator’s role in the Stockton bankruptcy, depicting it as essentially a service provider acting pursuant to a contract with the city. This is because the city is not obligated to use CalPERS to oversee its pensions; rather, it is free to use a private entity, an annuity, or a union to administer retirement benefits.<sup>103</sup> The court then defined the nature of the contractual relationships between and among the city, CalPERS, and pension beneficiaries:

If one were to diagram the relevant relationships, one would draw a triangle in which the corners are the City, CalPERS, and City employees. There are here distinct relationships. First, the City agrees with its employees to provide pensions. Second, the City agrees with CalPERS that CalPERS will administer City pensions by collecting payments from the City and investing those funds so as to produce enough to pay the pensions, and then paying on behalf of the City. Third, CalPERS promises City employees that it will pay the pensions.<sup>104</sup>

Thus, the contract is multilateral, and retirees are “intended third-party beneficiaries of the City’s contract with CalPERS.”<sup>105</sup>

Next, the court analyzed California law, finding that CalPERS does not actually bear the economic burden of the city’s nonpayment of its annual pension obligations because, in the event of a default by the city,

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<sup>99</sup> Amended Opinion Regarding Confirmation and Status of CalPERS, *In re City of Stockton, California*, Case No. 12-32118 (Bankr. E.D.Cal. Feb. 27, 2015).

<sup>100</sup> *Id.* at 2.

<sup>101</sup> 11 U.S.C. §365 allows debtors to accept or reject executory contracts.

<sup>102</sup> Amended Opinion Regarding Confirmation and Status of CalPERS, *In re City of Stockton, California*, Case No. 12-32118 (Bankr. E.D.Cal. Feb. 27, 2015), at 3.

<sup>103</sup> *Id.* at 8.

<sup>104</sup> *Id.* at 6.

<sup>105</sup> *Id.* at 7.

CalPERS is authorized to reduce pension benefits on a pro rata basis.<sup>106</sup> In other words, CalPERS is not required to pay underfunded pensions in full. Characterizing the agency as “merely a servicing agent,”<sup>107</sup> it observed that “it is the pensioners, present and future, . . . who are at risk of loss.”<sup>108</sup> The court concluded:

The key legal point to draw from this structure is that the authority of CalPERS to interject itself into the potential modification of a municipal pension in California under the Federal Bankruptcy Code is doubtful. As CalPERS does not guaranty payment of municipal pensions and had a connection with a municipality only if that municipality elects to contract with CalPERS to service its pensions, its standing to object to a municipal pension modification through chapter 9 appears to be lacking.<sup>109</sup>

At the same time, the court acknowledged that a city that elects to use CalPERS to manage its pensions “is not dealing with an ordinary contractual counterparty.”<sup>110</sup> The pension administrator enjoys tremendous competitive advantages derived from special protections under California law, and has a number of other strategic and organizational advantages over private or union administrators.<sup>111</sup> For instance, California law prohibits modification of a contract with CalPERS to service municipal pensions,<sup>112</sup> and imposes stiff exit costs for municipalities seeking to terminate a plan relationship with CalPERS.<sup>113</sup>

Notwithstanding these advantages, the court again emphasized that within bankruptcy, CalPERS is not even correctly classifiable as “the largest creditor of the City.”<sup>114</sup> The court clarified:

That obligation, if it exists, is a debt owed to past and present municipal employees. . . . CalPERS is a creditor in its own right only for the fees that it is permitted to charge for administering the City’s pensions. The

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<sup>106</sup> *Id.* at 25, citing CAL. GOV’T CODE §20577.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at 8.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.* at 10-14.

<sup>112</sup> PERL §20487.

<sup>113</sup> *See, e.g.*, PERL §20574.

<sup>114</sup> Amended Opinion Regarding Confirmation and Status of CalPERS, *In re City of Stockton, California*, Case No. 12-32118 (Bankr. E.D.Cal. Feb. 27, 2015), at 26.

real creditors are the employees, retirees, and their beneficiaries who will bear the burden of any reduction in the City's pensions.<sup>115</sup>

For these reasons, CalPERS is only really a creditor for fees and other amounts it is owed for administering the city's pension fund.<sup>116</sup> Meanwhile, the city's largest creditor was in fact a heterogeneous class of past and present employees who are owed retirement benefits, whether such benefits are paid through a plan administered by CalPERS.

For all of these reasons, rejection of the CalPERS contract would simply terminate the plan administration relationship between the city and CalPERS; a separate contractual promise would continue to exist between the city and its past and present employees for promised retirement benefits.<sup>117</sup> And, with respect to this latter contract, while it may *also* be rejected or unilaterally modified in bankruptcy, the court acknowledged that this should not be done "willy-nilly."<sup>118</sup> As in the case of collective bargaining agreements, something higher than the analogous "business judgment" standard ought to apply to a municipality's rejection or unilateral modification of a public pension plan:

[R]ejection requires a finding that the policy of successful rehabilitation of debtors would be served by rejection. In making that finding, the court must balance the interests of the affected parties - debtors, creditors, employees - and must consider the consequences of the alternatives on the debtor, on the value of creditors' claims and any ensuing hardship and the impact on employees. The court also must consider the degree of hardship faced by each party and must consider any qualitative differences between the types of hardship each may face.<sup>119</sup>

Although, at first blush, this balancing test seems to pave the way for moral arguments to govern whether a debtor ought to be permitted to reject or unilaterally modify its pensions in bankruptcy, the test is more nuanced, calling for a weighing of the economic burdens that have been allocated throughout the pendency of the Chapter 9 case and during the broader period of financial distress. This calls for deep, contextual analysis rather than sweeping determinations that certain types of creditors should always prevail.

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<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 50.

<sup>117</sup> *Id.* at 26.

<sup>118</sup> *Id.* at 47.

<sup>119</sup> *Id.*

Of course, the *Stockton* court never had an opportunity to apply its own test, as the debtor in that case did not propose to reject or unilaterally modify its pension promises. But the court used a similar approach to decide whether the debtor’s plan of adjustment unfairly discriminated against bondholders. Specifically, the court examined all of the economic concessions that had been made by parties to the case, both within and outside of the bankruptcy proceedings.<sup>120</sup> For instance, the court cited concessions that had been made by labor unions, past and present employees, and by existing and future retirees, such as the termination of retiree health care benefits valued at approximately \$550 million.<sup>121</sup> Thus, notwithstanding the court’s own declaration that the debtor had the legal right to reject or unilaterally modify its pensions in bankruptcy—thereby leading to a reduction in benefits for participants—the court concluded that it was reasonable for the debtor to maintain the plans fully intact because retirement benefit recipients had, as a class, made other concessions that were roughly equivalent to the concessions made by—or crammed down on—bondholders.<sup>122</sup>

Taken together, the judicial decisions described in this section provide some clarity regarding public pension claims in Chapter 9 bankruptcy. But all large bankruptcy restructurings—whether business or municipal—have the potential to become complex affairs, involving negotiated settlements that can deviate in large or small ways from legal rights and entitlements. The following Part examines three recent large Chapter 9 bankruptcies—those of Stockton, California, San Bernardino, California, and Detroit, Michigan—in an effort to understand how debtors ultimately gain support for restructuring plans that impair the rights of major creditors.

## II. CASE STUDIES: THE ANATOMY OF A CONFLICT

This Part presents detailed case studies from three recent municipal bankruptcies—Stockton, California, San Bernardino, California, and Detroit, Michigan. The case studies contribute to a deeper understanding of the political economy of large Chapter 9 cases. Specifically, the case studies focus on: (i) the ways in which bondholders and retirement

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<sup>120</sup> *Id.* at 50-55.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.* A plan may be crammed down on classes of creditors pursuant to the provisions of 11 U.S.C. §1129(b), which require a finding that the plan is “fair and equitable” and does not unfairly discriminate against the impaired, nonaccepting classes.

benefit recipients advanced their interests in the case; (ii) the ways in which bondholders and retirement benefit recipients negotiated with each other and with other stakeholders; and (iii) the impact of bondholders' and retirement benefit recipients' organizational constructs on their ability to make concessions. In this way, the case studies demonstrate that the realities of modern municipal bankruptcy process are much more nuanced than the moral framework suggests, and that there may be other reasons why debtors in recent cases have privileged public pension claims above capital market claims.

A. *STOCKTON, CALIFORNIA.*

Home to approximately three hundred thousand people,<sup>123</sup> the City of Stockton lies nestled in the heart of north-central California farmland, surrounded by the large natural wetlands of the Sacramento–San Joaquin River Delta.<sup>124</sup> Although only eighty-three miles from San Francisco, the inland port city seems a world away when its economic plight is contrasted against the City by the Bay's relative affluence.<sup>125</sup>

Stockton was thrust into the media spotlight in 2012, when it filed for Chapter 9 bankruptcy protection in the U.S. Bankruptcy Court for the Eastern District of California.<sup>126</sup> At the time, it was the largest U.S. city to ever file for bankruptcy.<sup>127</sup> In a statement addressing the decision, Mayor Ann Johnston explained, "[t]his is what we must do to get our fiscal house in order and protect the safety and welfare of our citizens."<sup>128</sup> Indeed, the city's struggles were already well-publicized during and after the Great

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<sup>123</sup> The total Stockton-Lodi, CA Metro Area population was 685,306 as of the 2010 census. U.S. Census Bureau, U.S. Dep't of Commerce, Annual Estimates of the Resident Population: April 1, 2010 to July 1, 2015 - United States -- Metropolitan and Micropolitan Statistical Area; and for Puerto Rico more information

2015 Population Estimates, Census Bureau Reports, <http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk>

<sup>124</sup> See generally CAROL ANN JENSEN, *THE CALIFORNIA DELTA* (2007) (providing a richly illustrated overview of the area's history);

<sup>125</sup> Stockton's contemporary economic problems are captured in NICK BURNETTE, *POVERTY IN AMERICA: A CLOSER LOOK AT STOCKTON, CA* (2015).

<sup>126</sup> See *supra* note 2.

<sup>127</sup> The record would later be broken by Detroit. Matthew Dolan, *Record Bankruptcy for Detroit*, WALL ST.J., Jul. 19, 2013.

<sup>128</sup> Jim Christie, *Stockton, California files for bankruptcy*, REUTERS, June 28, 2012.

Recession.<sup>129</sup> For instance, Stockton gained nationwide notoriety when, in 2008, it was dubbed “ground zero in the foreclosure crisis that shook the nation.”<sup>130</sup>

Stockton was driven to bankruptcy in part because of its own poor financial planning. When a nationwide housing boom generated increased tax revenues, both in the form of real property taxes and sales taxes,<sup>131</sup> city managers caused the city to incur massive long-term debt obligations with no regard for how it would weather a downturn. Between 2003 and 2009 alone, the city issued \$319 million in bonds to finance various projects.<sup>132</sup> To be sure, many of these projects were necessary for the growing metropolis. As Mayor Johnston explained in 2012, “Stockton had become the affordable housing for the Bay Area, so [the city] saw an influx of many Bay Area residents...buying brand new homes at very reasonable prices.”<sup>133</sup> The city responded to rapid population increases by expanding public services and launching new infrastructure projects.<sup>134</sup> After the real estate bubble burst, Stockton featured one of the nation’s highest rates of foreclosure, with home prices dropping at alarming rates.<sup>135</sup> Tax revenues dried up, and because the city did not have a reserve fund policy in place until June 2006,<sup>136</sup> it was especially vulnerable to periods of reduced revenues.

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<sup>129</sup> See, e.g., Marisa Lagos and Wyatt Buchanan, *Governor, educators talk budget woes in Stockton*, SAN FRANCISCO CHRON., Apr. 14, 2011 (detailing the city’s fiscal struggles); Kurt Badenhausen, *America’s Most Miserable Cities*, FORBES, Feb. 2, 2011 (ranking Stockton first on the list).

<sup>130</sup> City of Stockton’s Memorandum of Fact and Law in Support of its Statement of Qualifications, *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D.Cal. June 29, 2012), at 4.

<sup>131</sup> See, e.g., Reed Fujii, *Revenue will be largest since 1978*, RECORDNET.COM, Jul. 20, 2005; City of Stockton’s Memorandum of Fact and Law in Support of its Statement of Qualifications, *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D.Cal. June 29, 2012), at 4.

<sup>132</sup> Alison Vekshin, *Stockton Gorged on Debt for City Amenities Before Crash*, BLOOMBERG, Apr. 3, 2012.

<sup>133</sup> Richard Gonzales, *An Example to Avoid: City of Stockton on the Brink*, NPR, Mar. 11, 2012.

<sup>134</sup> City of Stockton’s Memorandum of Fact and Law in Support of its Statement of Qualifications, *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D.Cal. June 29, 2012), at 5.

<sup>135</sup> See, e.g., Noelle Knox, *Stockton, Calif.: Housing Market is ‘still sliding’*, USA TODAY, Aug. 13, 2007.

<sup>136</sup> CITY OF STOCKTON COMPREHENSIVE ANNUAL FINANCIAL REPORT, at viii.

Although the city attempted to rein in spending as tax revenues dried up, its obligations continued to increase; this was primarily because it had earlier promised employees generous retirement benefits without properly funding them. For instance, commencing in the 1990s, the city began offering lifetime health insurance coverage for each retiree and one dependent; what began as a concession for the city’s firefighters during contentious negotiations quickly expanded until it became a standard offering for city employees.<sup>137</sup> But instead of engaging in actuarially sound practices with respect to the promised coverage, such as setting aside funds annually to meet future obligations, the city chose to fund these obligations on a “pay-as-you-go basis.”<sup>138</sup> As health care costs steadily increased—along with the life expectancy of beneficiaries—the financial burden drastically expanded.<sup>139</sup> Meanwhile, also in the 1990s, in response to California’s then-Governor Gray Davis’s pension benefit enhancements for the California Highway Patrol, Stockton—like many other cities throughout the state—hiked pension benefits for its own employees.<sup>140</sup> The city reduced the normal retirement age to 50 for public safety employees and 55 for all other employees,<sup>141</sup> causing pension obligations to increase exponentially. In bankruptcy court filings, city officials identified expanding pension obligations as a “main driver” of ongoing budget deficits.<sup>142</sup>

Beginning in 2008, Stockton sought to balance its budget through voluntary reductions in employee compensation and benefits, by imposing furloughs and hiring freezes, and by outright terminating some

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<sup>137</sup> See, e.g., Jim Christie, *How Stockton went broke: A 15-year spending binge*, REUTERS, Jul. 3, 2012.

<sup>138</sup> City of Stockton’s Memorandum of Fact and Law in Support of its Statement of Qualifications, *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D.Cal. June 29, 2012), at 6.

<sup>139</sup> *Id.*

<sup>140</sup> Alison Vekshin, James Nash & Rodney Yap, *Police Chief’s \$204,000 Pension Shows How Cities Crashed*, BLOOMBERG.COM, Jul. 31, 2012.

<sup>141</sup> AMENDMENT TO CONTRACT BETWEEN THE BOARD OF ADMINISTRATION CALIFORNIA PUBLIC EMPLOYEES’ RETIREMENT SYSTEM AND THE CITY COUNCIL CITY OF STOCKTON, March 16, 2002, available at [http://www.stocktongov.com/abDocs/600\\_Cal\\_PERS\\_COS\\_Contract\\_Amend\\_2002\\_3\\_02.pdf](http://www.stocktongov.com/abDocs/600_Cal_PERS_COS_Contract_Amend_2002_3_02.pdf).

<sup>142</sup> Declaration of Laurie Montes in Support of City of Stockton’s Statement of Qualifications, *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D.Cal. June 29, 2012), at 2.

employees.<sup>143</sup> For instance, in 2009, under threat of layoffs, the police union agreed to renegotiate its contract with Stockton, making approximately \$7.3 million in concessions; in the same year, the firefighters union agreed to a deal that involved \$7.2 million in concessions.<sup>144</sup> But as budgetary pressures continued, the city eventually laid off 29 police officers in 2010.<sup>145</sup> By 2011, as economic conditions worsened, the city terminated nearly a third of its fire department and more than forty percent of its non-uniformed workforce.<sup>146</sup> At the same time, the city further reduced the size of its police force, laying off another 26 officers while slashing pay and benefits by twenty percent.<sup>147</sup> Some observers linked the reductions in police funding to a dramatic uptick in crime.<sup>148</sup>

Despite these measures, the city's financial distress continued. By early 2012, a bankruptcy filing became imminent. The city signaled its intentions by defaulting on obligations to its capital market creditors, declining to make a two million dollar payment to bondholders.<sup>149</sup> Under California law, municipalities are required to engage in workout negotiations as a condition precedent to a bankruptcy filing.<sup>150</sup> Thus, in February 2012, the city initiated mediation with nearly all of its largest creditors.<sup>151</sup> But after months of confidential talks failed to yield a settlement, the city still faced a projected deficit of \$26 million for the

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<sup>143</sup> Declaration of Ann Goodrich in Support of City of Stockton's Statement of Qualifications, *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D.Cal. June 29, 2012), at 3.

<sup>144</sup> David Siders, *Stockton police OK deal to halt layoffs*, RECORDNET.COM, Jul. 16, 2009.

<sup>145</sup> *29 police laid off*, RECORDNET.COM, Feb. 7, 2009.

<sup>146</sup> See, e.g., Jerry White, *Judge backs Stockton, California bankruptcy plan ending retiree health care payments*, Oct. 31, 2014; Alan Greenblatt, *What It's Like Living in a Bankrupt City*, NPR, Sept. 6, 2013.

<sup>147</sup> John Rudolf, *Stockton's Poor Mired In Violence After Police Cuts, Recession*, HUFFINGTON POST, March 19, 2012.

<sup>148</sup> See *id.*

<sup>149</sup> Alison Vekshin, *Stockton Going Broke Shows Cop Pay Rising as Property Collapsed*, BLOOMBERG, Feb. 29, 2012.

<sup>150</sup> CAL. GOV'T CODE §53760(a), 53760.3.

<sup>151</sup> Declaration of Marc A. Levinson in Support of Emergency Motion for Leave to Introduce Evidence Relating to Neutral Evaluation Process, *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D.Cal. June 29, 2012), at 2.



upcoming fiscal year.<sup>152</sup> With seemingly no other choice, it sought Chapter 9 bankruptcy protection on June 28, 2012.<sup>153</sup>

In first-day filings, the city claimed that its largest creditor was CalPERS—administrator of the city’s pension plan—which held an estimated \$148 million contingent, unliquidated claim for unfunded pension costs.<sup>154</sup> Since September 1944, the city has contracted with CalPERS to provide retirement benefits for its employees.<sup>155</sup> Accordingly, the city’s employees are members of CalPERS and the city is bound by the terms of California’s Public Employees’ Retirement Law (“PERL”).<sup>156</sup> Pursuant to the terms of the contract, the city is required to make regular payments to CalPERS in exchange for maintaining full pension benefits for employees.<sup>157</sup> As the previous Part highlighted, in order to terminate its contract with CalPERS, a contracting agency must pay a so-called termination fee—generally a hefty sum that is intended to allow CalPERS to continue to administer pension payments for the agency’s current and retired employees who were already members of CalPERS at the time of the termination.<sup>158</sup> For Stockton, the termination fee would be approximately \$1.6 billion; failure to pay would cause CalPERS to reduce payments to beneficiaries by approximately 60%.<sup>159</sup>

The City’s next largest debts were owed to so-called capital market creditors, including approximately \$124 million in pension obligation bonds, \$40 million in variable rate demand obligations, \$35 million in public facilities fees bonds, and \$32 million in parking garage construction

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<sup>152</sup> City of Stockton’s Memorandum of Fact and Law in Support of its Statement of Qualifications, *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D.Cal. June 29, 2012), at 19.

<sup>153</sup> *See supra* note 2.

<sup>154</sup> List of Creditors Holding 20 Largest Unsecured Claims, *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D.Cal. June 28, 2012).

<sup>155</sup> *See* CONTRACT BETWEEN CITY COUNCIL OF CITY OF STOCKTON AND THE BOARD OF ADMINISTRATION OF THE CALIFORNIA STATE EMPLOYEES’ RETIREMENT SYSTEM, Sept. 1, 1944, available at [http://www.stocktongov.com/abDocs/600\\_CalPERS\\_COS\\_Contract\\_1944\\_9\\_01.pdf](http://www.stocktongov.com/abDocs/600_CalPERS_COS_Contract_1944_9_01.pdf).

<sup>156</sup> *See id.*

<sup>157</sup> *Id.*

<sup>158</sup> The fee is authorized pursuant to Cal. Gov’t Code §20574. On Stockton’s potential termination fee, *see generally, e.g.*, Tim Reid, *California city looks to quit Calpers, fears it can’t afford to*, REUTERS, Aug. 27, 2014 (explaining the process with respect to another California city).

<sup>159</sup> Michael Hiltzik, *In Stockton bankruptcy case, the target is the working class*, LA TIMES, Oct. 2, 2014.

bonds.<sup>160</sup> Stockton, facing hefty annual payments to CalPERS, followed the lead of many other state and local governments around the country and used pension obligation bonds to satisfy unfunded pension costs.<sup>161</sup> Unfortunately, the gamble did not pay off for Stockton; timing is critical, and the city issued its pension obligation bonds in 2007, just before the market crashed.<sup>162</sup> In sum, Stockton entered bankruptcy with approximately \$700 million in bond debt.<sup>163</sup>

Although the city listed CalPERS as the holder of the largest claim, the city's retirement benefit recipients, as a class, were in reality the largest creditor. In filings, the city acknowledged approximately 2,400 retirees, 1,100 of whom had been promised medical benefits in addition to regular pension benefits.<sup>164</sup> Retirees were initially represented in pre- and post-petition negotiations by the Association of Retired Employees of the City of Stockton ("ARECOS").<sup>165</sup> Later, the U.S. Trustee appointed an official committee to represent retirees.

The city eventually gained consensus from all but one major creditor—mutual fund Franklin Templeton Investments, a bondholder ("Franklin"). Franklin objected to the city's proposed plan of adjustment that contemplated paying CalPERS in full, implementing an additional three quarter cent sales tax, terminating certain retiree health care benefits, and paying bondholders approximately 10 to 20 percent of their claims. The mutual fund giant complained that "no bondholder has ever received so little in the history of municipal bankruptcy,"<sup>166</sup> and asserted that the plan was not proposed in good faith. The court conducted the balancing test described in the previous Part, concluding that although pensions were not impaired, the rights of employees and retirees more broadly were

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<sup>160</sup> *Id.*

<sup>161</sup> Cate Long, *How bankrupt Stockton, CA was sold pension obligation bonds*, REUTERS, Sept. 7, 2012.

<sup>162</sup> Mary Williams Walsh, *How Plan to Help City Pay Pension Backfired*, NY TIMES, Sept. 3, 2012.

<sup>163</sup> Katy Stech, *California City's Bankruptcy Poses Risks to Pensions*, WALL ST.J., Apr. 1, 2013 (describing some of the inherent risks of pension obligation bonds).

<sup>164</sup> See, e.g., Letter from Marc A. Levinson to Antonia G. Darling, July 1, 2013, in City's Submission of Response to Request for Appointment of Official Taxpayers' Committee, *In re City of Stockton, California*, Case No. 12-32118 (Bankr. E.D.Cal. July 1, 2013).

<sup>165</sup> See, e.g., Complaint for Declaratory and Injunctive Relief, *In re City of Stockton, California*, Case No. 12-32118 (Bankr. E.D.Cal. July 1, 2013).

<sup>166</sup> Max Whittaker, *U.S. court tosses Franklin's appeal of Stockton bankruptcy plan*, REUTERS, Dec. 11, 2015.

profoundly impaired, either by the plan or by previous concessions that reduced compensation and benefits for past, present, and future employees.<sup>167</sup> After the court confirmed the city's plan over Franklin's objections in early 2015,<sup>168</sup> the mutual fund appealed; but the Ninth Circuit dismissed the appeal later that same year on equitable mootness grounds.<sup>169</sup>

#### B. SAN BERNARDINO, CALIFORNIA.

One of the oldest settlements in California, the City of San Bernardino, California is situated approximately sixty miles east of Los Angeles, resting in the San Bernardino Valley in the southeast portion of the state.<sup>170</sup> Despite its tree-lined streets and views of a mountain range that shares its name, the city has faced major challenges in recent decades. In particular, following the loss of several major employers and the closing of the Norton Air Force Base in the mid-1990s—bringing an end to approximately ten thousand military and civilian jobs<sup>171</sup>—the city has struggled with high rates of unemployment. Meanwhile, like many other cities in California and the rest of the nation, San Bernardino has had difficulty keeping up with rising costs and expanding employee benefit costs; in 2005, the city issued more than \$50 million in pension obligation bonds in an effort to stay afloat and possibly even improve its financial position.

But economic conditions only worsened. Much like Stockton, the city was severely impacted by the housing boom and bust. “Between 2007 and 2012, San Bernardino residential housing prices plummeted resulting in significantly lower property tax revenues.”<sup>172</sup> Recent census data ranked the city the second poorest in the nation, following Detroit.<sup>173</sup>

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<sup>167</sup> *In re* City of Stockton, 526 B.R. 35 (Bankr. E.D. Cal 2015).

<sup>168</sup> *In re* City of Stockton, 526 B.R. 35 (Bankr. E.D. Cal 2015).

<sup>169</sup> *See supra* note 166.

<sup>170</sup> On the history and geography of San Bernardino, *see, e.g.*, STEVEN SHAW, SAN BERNARDINO (2008); EDWARD LEO LYMAN, SAN BERNARDINO: THE RISE AND FALL OF A CALIFORNIA COMMUNITY (1996).

<sup>171</sup> On the base closure, see Jan Sears, *Norton Air Force Base: Shutdown a Third Strike for San Bernardino*, PRESS ENTERPRISE, March 27, 2014.

<sup>172</sup> Third Amended Disclosure Statement With Respect to the Third Amended Plan for the Adjustment of Debts of the City of San Bernardino, California, *In re* City of San Bernardino, Case No. 6:12-bk-28006-MJ (Bankr. Cent.D.Cal. July 29, 2016), at 14.

<sup>173</sup> Joe Mozingo, *San Bernardino: Broken City*, L.A. TIMES, June 14, 2015.

Signs of severe financial distress in San Bernardino first began to emerge in 2008, and by 2012 the situation had “reached a critical point.”<sup>174</sup> At that time, the city was operating with a \$45 million budget deficit.<sup>175</sup> In response to these pressures, the city council in July 2012 unanimously agreed to institute a “Fiscal Emergency Operating Plan,” which included deferment of more than \$3.5 million in debt and lease payments, \$2.2 million in annual contributions for retiree health care benefits, postponement of capital projects, continuation of employee vacancies, and the extension of almost \$3 million in employee concessions.<sup>176</sup>

Soon after, the city sought bankruptcy protection under Chapter 9, filing a voluntary petition with the U.S. Bankruptcy Court for the Central District of California on August 1, 2012.<sup>177</sup> After more than a year of eligibility determination proceedings, the court approved the city’s filing and the U.S. Trustee appointed an official retiree committee to represent the interests of retired city employees.

But even before the October 2013 formation of an official committee, the city was making decisions that had the potential to severely impact retiree and employee interests. Notably, within months of the bankruptcy filing, the city defaulted on its annual obligations to CalPERS.<sup>178</sup> This move caused some observers to speculate that the city would try to use the bankruptcy process to modify its pension obligations. But after months of confidential mediation between the city and CalPERS, the city in June 2014 agreed that it would only pursue a plan of adjustment that paid the city’s obligations to CalPERS in full, with interest, and that ratified the city’s relationship with the pension administrator.<sup>179</sup> The official retiree committee later backed this agreement, consenting to dramatic reductions in retiree health care benefits so long as the city maintained its relationship with CalPERS.

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<sup>174</sup> Special Council Session Set for Tomorrow, Office of the City Manager Press Release, July 9, 2012.

<sup>175</sup> Tim Reid, *San Bernardino has defaulted on \$10 million in bond payments*, REUTERS, March 17, 2015.

<sup>176</sup> San Bernardino Fiscal Emergency Operating Plan, Office of the City Manager Press Release, July 24, 2012.

<sup>177</sup> Voluntary Petition of City of San Bernardino, *In re* City of San Bernardino, Case No. 6:12-bk-28006-MJ (Bankr. C.D.Cal., Aug. 1, 2012).

<sup>178</sup> City’s Deferral of CalPERS Payments, Office of the City Manager Press Release, Oct. 29, 2012.

<sup>179</sup> Confidential Settlement Agreement, Exh. 27 to Disclosure Statement.

Consistent with these negotiated settlements, city officials initially proposed a plan of adjustment that would pay CalPERS in full, while bondholders would receive only one percent of the obligations owed to them.<sup>180</sup> At the time, city officials apologetically explained, “It’s obviously a tiny offer. From a fairness point of view, it looks like an insulting offer. But it is not an insult. Given the city’s circumstances, it is all the city can afford.”<sup>181</sup> But bondholders were not convinced. After several years of litigation, tense negotiations, and multiple revisions to the debtor’s proposed plan of adjustment, the city and holders of its pension obligation bonds finally reached a settlement that paid CalPERS in full while repaying bondholders approximately thirty to forty percent of their claims.<sup>182</sup>

In defense of the plan, city officials pointed out that retirees also received a proverbial “haircut,” as the city had severely reduced retiree health care benefits.<sup>183</sup> Moreover, notwithstanding its decision to pay CalPERS in full, the city had used the bankruptcy process to impair a smaller, supplemental pension plan that had been established to provide benefits to twenty-three police officers who retired between 2003 and 2007. The supplemental plan, managed by an entity known as Public Agency Retirement System (“PARS”), enabled these officers to receive the same total retirement benefits that other police officers were receiving elsewhere in the state. In its initial draft plan of adjustment, the city proposed a distribution of one percent of the obligations owed to the PARS plan recipients. Beneficiaries rejected this offer, arguing that it was “immoral.”<sup>184</sup> Nearly two years after the city had agreed to pay CalPERS in full, the city continued to drag its feet on settling with PARS beneficiaries: according to a retiree representative, “[t]he PARS retirees made an offer to the city in January 2016 for an amount much lower than 40 cents on the dollar, and the city, as of [March 2016], ha[d] not even

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<sup>180</sup> See, e.g., Ryan Hagen, ‘Major step forward’ for San Bernardino bankruptcy, SAN BERNARDINO SUN, Apr. 1, 2016; Paloma Esquivel & Joe Mozingo, *San Bernardino’s bankruptcy plan favors CalPERS*, LA TIMES, May 18, 2015.

<sup>181</sup> Tim Reid, *San Bernardino bankruptcy plan: bondholders hammered while pensions kept whole*, REUTERS, May 14, 2015.

<sup>182</sup> Rory Carroll, *San Bernardino settlement bad for pension bondholders: Moody’s*, REUTERS, Apr. 4, 2016.

<sup>183</sup> *Id.*

<sup>184</sup> Ryan Hagen, *San Bernardino reaches settlement with police retiree group*, SAN BERNARDINO SUN, May 2, 2016.

given the PARS retirees the courtesy of a response.”<sup>185</sup> Eventually, in May 2016, the city reached a settlement with the plan beneficiaries, providing for rejection of the PARS supplemental pension plan, distribution of the plan’s assets to plan participants, and two additional lump-sum payments.<sup>186</sup>

The city’s rejection of the PARS plan suggests that its decision to pay CalPERS in full did not simply reflect a moral determination that retiree claims are more deserving than those of Wall Street creditors. Acknowledging the different treatment of the two groups of pension claims, city officials pointed to a more pragmatic—albeit nonetheless employee-centric—concern: the CalPERS plan, unlike the PARS plan, provided benefits for existing *and* future employees. But even this rationalization is seemingly challenged by the city’s eventual pursuit of a plan of adjustment that relied extensively on outsourcing of city services—including annexation of the fire department to the county—to reduce the percentage of workers eligible for city benefits and thereby reduce labor costs.<sup>187</sup> Sidestepping these obvious contradictions, the city manager hinted that there is another reason city leaders chose to pay CalPERS in full: the pension fund would “litigate relentlessly if they didn’t pay. ‘They would take it all the way to the Supreme Court.’”<sup>188</sup>

Of course, the outcomes of the San Bernardino and Stockton bankruptcies may—at least to some extent—reflect CalPERS’ unique position as a powerful legal adversary with considerable bargaining power, political clout, and state law protections. The following section explores the Detroit bankruptcy, drawing an interesting comparison to San Bernardino and Stockton.

### C. DETROIT, MICHIGAN.

An iconic symbol of the failing U.S. automotive industry, the City of Detroit, Michigan, is also a frequently cited example of urban blight and

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<sup>185</sup> Ryan Hagen, *San Bernardino settlement: Pension obligation bondholders to get 40%*, SAN BERNARDINO SUN, March 30, 2016.

<sup>186</sup> Third Amended Disclosure Statement With Respect to the Third Amended Plan for the Adjustment of Debts of the City of San Bernardino, *In re City of San Bernardino*, Case No. 6:12-bk-28006-MJ (Bankr. C.D.Cal., July 29, 2016), at 58-60.

<sup>187</sup> See, e.g., Stephanie Cumings, *San Bernardino Free to Outsource Firefighting Services*, BANKRUPTCY LAW REPORTER, Jan. 5, 2016.

<sup>188</sup> Rory Carroll, *San Bernardino settlement bad for pension bondholders: Moody’s*, REUTERS, Apr. 4, 2016.

the challenges of depopulation and declining municipal revenue.<sup>189</sup> But in recent years, the city made new headlines when, in March 2013, the State of Michigan appointed veteran bankruptcy lawyer Kevyn Orr as the city's emergency manager.<sup>190</sup> Then, on July 18, 2013, it filed the largest municipal bankruptcy case in U.S. history in the U.S. Bankruptcy Court for the Eastern District of Michigan.<sup>191</sup> In court filings, the city projected a \$198 million annual cash flow shortfall for the 2014 fiscal year, along with scheduled debts of \$18 to 20 billion. The city spent eighteen months in Chapter 9, with the sheer magnitude of the case capturing the attention of bankruptcy experts,<sup>192</sup> urban affairs analysts, and political and financial journalists around the country.<sup>193</sup>

Like its bankrupt peer cities in California, Detroit's major creditors included participants in the city's entirely unfunded retiree health plan, participants in partially-funded pension plans, and capital market creditors. But, unsurprisingly, CalPERS was not a party to the proceedings; instead, the city's pensions were managed by two entities: the General Retirement System of the City of Detroit, and the Police and Fire Retirement System of the City of Detroit (collectively, the "Retirement Systems").<sup>194</sup> The Retirement Systems initially filed a lawsuit to prevent the city from resorting to Chapter 9 bankruptcy,<sup>195</sup> but the city was given the green light to pursue bankruptcy protection over objections. An official committee of retirees was formed within weeks of the filing to represent the interests of more than 23,000 city retirees and their beneficiaries.<sup>196</sup>

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<sup>189</sup> See, e.g., Nicole Hardesty, *Haunting Images Of Detroit's Decline*, HUFFINGTON POST, Mar. 23, 2011.

<sup>190</sup> Monica Davey, *Bankruptcy Lawyer is Named to Manage an Ailing Detroit*, N.Y. TIMES, March 14, 2013.

<sup>191</sup> Voluntary Petition of City of Detroit, *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D.Mich., July 18, 2013).

<sup>192</sup> For a more thorough case study, based in part on real-time monitoring of the case, see Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55 (2016).

<sup>193</sup> For a lively and thorough account of the case, see NATHAN BOMEY, DETROIT RESURRECTED: TO BANKRUPTCY AND BACK (2016).

<sup>194</sup> *City of Detroit Pension Funds File Lawsuit to Block Bankruptcy Filing*, PRNEWswire, July 17, 2013.

<sup>195</sup> See *id.*

<sup>196</sup> Order, Pursuant to Section 1102(a)(2) of the Bankruptcy Code, Directing the Appointment of a Committee of Retired Employees, *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D.Mich., Aug. 2, 2013).

Contributing to Detroit's economic problems was a series of financing arrangements entered into in 2005 and 2006 to satisfy a shortfall in the city's contributions to the Retirement Systems.<sup>197</sup> Instead of issuing pension obligation bonds, the city issued approximately \$1.5 billion of so-called certificates of participation ("COPs"). This creative deal structure was designed to sidestep laws that restricted the city's borrowing. A portion of the COPs carried a variable interest rate; the city used rate swaps to manage the risk. But the swap agreements contained provisions that enabled counterparties to terminate the swaps under specified conditions and collect hefty termination payments. Such conditions included a credit rating downgrade of the city to a level below investment grade, appointment of an emergency city manager, and failure of the city to satisfy obligations. Following the occurrence of these events, counterparties claimed \$250-350 million in swap termination payments. These and other creditors were initially represented by an official committee of unsecured creditors, which was appointed approximately five months after the bankruptcy case was filed.<sup>198</sup>

At the commencement of the bankruptcy case, city officials warned that there would be severe cuts to pension benefits for current and former employees.<sup>199</sup> An early draft plan of adjustment contemplated pension cuts of 10-34%.<sup>200</sup> But negotiations with public pension claimants would soon be overshadowed by other skirmishes. Within months of the U.S. Trustee's formation of the official committee of unsecured creditors, the city moved to have the court disband the official committee on the grounds that the capital market creditors were already advocating on their own behalf and the pension claims were adequately represented by the official committee

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<sup>197</sup> The explanation provided here is based on analyses set forth in Brian J. O'Connor, *Detroit facing challenges one year after bankruptcy*, DETROIT NEWS, Dec. 10, 2015; Wallace Turbeville, *The Detroit Bankruptcy*, DEMOS, Nov. 20, 2013.

<sup>198</sup> Notice of Appointment of Official Committee of Unsecured Creditors, *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D.Mich., Dec. 23, 2013).

<sup>199</sup> See, e.g., Melanie Hicken, *Detroit's workers and retirees face big cuts*, CNN.COM, July 18, 2013.

<sup>200</sup> Eyder Peralta, *Detroit bankruptcy plan proposes 34 percent cut to pensions*, NPR, Feb. 21, 2014.



of retirees.<sup>201</sup> The court agreed, dismantling the committee of unsecured creditors in February 2014.<sup>202</sup>

From there, conflicts only intensified. City managers filed a lawsuit seeking to declare the COPs *void ab initio*, calling the entire borrowing transaction a “sham” that was essentially foisted on the city by greedy Wall Street bankers.<sup>203</sup> In contemporaneous comments on the city’s move, bond rating giant Moody’s explained that “[t]he attempted repudiation of municipal debt is an extremely rare and unusual act.”<sup>204</sup> Soon thereafter, Financial Guaranty Insurance Company (“Financial Guaranty”), a company which had guaranteed the COPs, filed a countersuit alleging that the city was unlawfully discriminating against capital market creditors and that the court should authorize a so-called “clawback” of the borrowed funds from pension assets.<sup>205</sup> Later, Financial Guaranty and other major capital market creditors argued that the city had failed to take into account substantial assets it owned through its Detroit Institute of Arts, which had been “appraised at over \$8 billion” and which was “self-described as containing one of the top six collections in the United States.”<sup>206</sup> The creditors called on the debtor to monetize the artwork, such as by using it as collateral to refinance its obligations.<sup>207</sup>

Despite these ever-growing rifts, Detroit was eventually able to gain approval of its eighth draft plan of adjustment. Compromise was reached pursuant to what is now famously called the “grand bargain.”<sup>208</sup> This negotiated settlement contemplated pledges of \$366 million from philanthropic organizations—with an understanding that the state

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<sup>201</sup> Motion of Debtor for Entry of an Order Vacating the Appointment of Official Committee of Unsecured Creditors, *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D.Mich., Jan. 31, 2014).

<sup>202</sup> Order Granting the City’s Motion to Vacate the Appointment of the Official Committee of Unsecured Creditors, *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D.Mich., Feb. 28, 2014).

<sup>203</sup> Mary Williams Walsh, *Bond Insurer Files Suit Against Detroit in Setback for Bankruptcy Plan*, N.Y.TIMES, Mar. 17, 2014.

<sup>204</sup> Caitlin Devitt, *Moody’s Sees Detroit COPs Repudiation as Isolated*, BONDBUYER.COM, Feb. 14, 2014.

<sup>205</sup> Mary Williams Walsh, *Bond Insurer Files Suit Against Detroit in Setback for Bankruptcy Plan*, N.Y.TIMES, Mar. 17, 2014.

<sup>206</sup> Joint Pretrial Brief in Support of Objection to DIA Settlement, *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D.Mich., Aug. 27, 2014), at 2.

<sup>207</sup> *Id.*

<sup>208</sup> *See, e.g.*, Notice of Filing of Letter Agreement With Retiree Committee, *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D.Mich., Nov. 5, 2014).

government, private companies, and public employee unions would also contribute—to prevent collateralization of the city’s extensive artwork collection and preserve pensions.<sup>209</sup> A trust was established to hold donor funds and use them to pay the city’s annual pension obligations.<sup>210</sup> Although the plan kept the pension plans intact, Detroit’s retirement benefit recipients would make some concessions. The plan of adjustment contemplated a 4.5 percent reduction in pension benefits for most employees,<sup>211</sup> an end to certain cost-of-living increases, a freeze on new enrollments in the existing pension plan,<sup>212</sup> and a return of excess interest paid by the city on employee savings accounts.<sup>213</sup> Meanwhile, capital market creditors made concessions as well, receiving 34 to 74 cents for every dollar owed.<sup>214</sup> The court confirmed the plan in November 2014, over remaining bondholder objections,<sup>215</sup> allowing the city to exit bankruptcy.<sup>216</sup>

### III. DISCUSSION

On the surface, the Chapter 9 bankruptcy restructurings of Stockton, San Bernardino, and Detroit suggest that employee-centric principles of fairness and equity—specifically, the argument that retirement benefit recipients have a higher moral claim to repayment—are driving municipal restructuring outcomes. After all, in each of these three cases, powerful and sophisticated parties ultimately agreed on—or, in the case of holdouts, the court crammed down—plans of adjustment that deviate in substantial ways from legal rights and entitlements, privileging the claims of

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<sup>209</sup> See HOWARD HUSOCK, *THE PENSION GRAND BARGAIN: A NEW REFORM MODEL FOR CITIES* (2016).

<sup>210</sup> *Id.* at 6.

<sup>211</sup> The cuts did not apply to police and fire retirees.

<sup>212</sup> *Id.*

<sup>213</sup> Chris Christoff, *Detroit Pension Cuts From Bankruptcy Prompt Cries of Betrayal*, BLOOMBERG, Feb. 4, 2015.

<sup>214</sup> Brian Chappatta, *Detroit Leaves Legacy of Tarnished Pledge for Muni Bond Buyers*, BLOOMBERG, Nov. 9, 2014.

<sup>215</sup> Oral Opinion on the Record of Judge Rhodes, *In re City of Detroit*, No. 13-53846 (Bankr. E.D.Mich. Nov. 7, 2014), at 30 (addressing the cramdown). The court famously based the cramdown decision on the court’s “judgment of its conscience regarding...discrimination.” *Id.* The cramdown is explored in Andrew B. Dawson, *Pensioners, Bondholders, and Unfair Discrimination in Municipal Bankruptcy*, 17 U. PA. J. BUS. L. 1 (2015).

<sup>216</sup> Order Confirming Eighth Amended Plan for the Adjustment of Debts of the City of Detroit, *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D.Mich., Nov. 12, 2014).

retirement benefit recipients over the claims of Wall Street investors. Taken together, the cases evidence an emerging prototypical municipal bankruptcy restructuring that seems to advance important moral and equitable interests.

But below the surface, the story is more complicated. The case studies expose a political economy of Chapter 9 bankruptcy that appears to impact case outcomes as much as—or more than—equitable arguments that universally favor particular claims or claimants. Indeed, as I've written elsewhere, bankruptcy process relies to a large extent on negotiated settlement rather than judicial edict.<sup>217</sup> This is especially true of Chapter 9, in light of the federalism concerns and the debtor's necessarily greater autonomy. But it also means that the outcomes of large and complex bankruptcy cases are often predetermined based on *who* is invited to the negotiation table and *when*; if parties in interest are unable to effectively advocate for their rights, or if they are given a seat at a much later stage in the proceedings, then it is unlikely that they will be able to effectively influence the proceedings.<sup>218</sup> This is because debtors and other powerful parties often behave in strategic ways, forming alliances early in the case and applying pressure to develop consensus around restructuring plans that advance their own economic interests.

The case studies also suggest that municipal debtors, like all debtors, work to develop consensus by negotiating first with those stakeholders who are perceived to be the most powerful within and outside of bankruptcy. Stakeholders may derive their clout from their existing market power in the capital and securities markets, from their political power in relevant jurisdictions, or from longstanding perceptions regarding their legal rights and entitlements or the political or moral strength of their claims. All of these forces appear to have aligned to benefit CalPERS, allowing it to gain an early, strategic advantage for the benefit of pension beneficiaries in Stockton and San Bernardino. Indeed, in both cases, CalPERS was negotiating with the debtor long before an official committee of retirees was even formed, in part because of state laws that mandate negotiation before the U.S. Trustee or bankruptcy court even have jurisdiction over the matter.

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<sup>217</sup> See generally Diane Lourdes Dick, *The Chapter 11 Efficiency Fallacy*, 2013 B.Y.U. L. Rev. 759 (2013).

<sup>218</sup> See generally Diane Lourdes Dick, *Grassroots Shareholder Activism in Large Commercial Bankruptcies*, 40 J. CORP. L. 1 (2014) (making this argument in the loosely analogous Chapter 11 bankruptcy context).

In contrast, the much smaller and less influential Public Agency Retirement System in San Bernardino was effectively shut out of negotiations, with the debtor allegedly refusing to even respond to a reasonable settlement offer. The differing treatment may reflect the fact that PARS was only a supplemental plan, and thus not the primary retirement asset for program participants. But in Detroit, the Retirement Systems *also* do not appear to have enjoyed as much inherent power and influence; this likely contributed to the city's decision to propose an initial plan of adjustment that would severely impair pension beneficiaries. In the end, though, Detroit's deeper rifts with capital market creditors—along with public pressure to avoid a pledge of the city's extensive artwork collection—seem to have encouraged compromise from all sides, allowing pension beneficiaries to fare quite a bit better than they would have under the debtor's initially proposed plan.

Similarly, other retiree benefit claims, such as health care benefits, were categorically wiped out in these bankruptcy cases. Of course, depending upon each individual retiree's age and health status, health care coverage may not be as vital as pension benefits. This is because Medicaid, Medicare, or private health insurance policies may provide sufficient coverage. Nonetheless, the decision to preserve pensions and eradicate health care benefits appears not to have been made on the basis of thoughtful assessment of retirees' economic needs and preferences, but rather on the basis of structural realities: the pension plans were represented by powerful and prominent advocates, while the health care benefits were more decentralized and less politically charged.

The case studies also suggest that retiree concessions were largely determined top down, with the debtor focusing its negotiations on those entities with the most bargaining power. Although official committees of retirees were formed in each case, they do not always appear to have played a leading role in negotiations; for instance, in San Bernardino, the committee seems to have merely rubberstamped an agreement already reached by the debtor and CalPERS.

Of course, the committee may have been happy to rubberstamp a deal that benefited its members. Even taking into account the relatively modest concessions made by pensioners in Detroit, it is undeniable that these recent, large Chapter 9 cases have privileged retirement benefit recipients over other claimants. At least on the surface, these cases seem like positive developments for retirement benefit recipients and workers more broadly, demonstrating how bankruptcy process can protect important public

policy goals. But do the case outcomes actually advance the social interests sought to be promoted by the moral framework? This is less clear. For one thing, the prevailing moral discourse inaccurately portrays municipal employees as a unitary class, essentially co-opting the rallying call of past, present, and future workers for the benefit of what is often a narrowly defined group of legacy pension claimants. Not all city workers benefit from the prototypical municipal restructuring and many—such as those who are laid off prepetition and those who are given significantly reduced future benefits—are harmed. This is not to mention the broader societal impacts, such as reductions in city services and increased taxes to offset expanding legacy pension-related costs.

Moreover, the binary distinction drawn between sympathetic and less financially-secure pension claimants, on the one hand, and wealthy, Wall Street-based capital market creditors, on the other, is also overly simplistic. Just as CalPERS and other pension fund administrators advocate on behalf of large and heterogeneous groups of interested persons, so, too, do institutional creditors represent a wide range of investors. Without a doubt, this includes small retail investors, employees, and retirees from around the country who directly and indirectly invest an estimated \$24 trillion of retirement assets in the financial markets. And, in the case of pension obligation bonds, it seems especially short-sighted to allocate economic burdens solely to capital market creditors—which likely encompass, directly or indirectly, the retirement assets of countless workers—in order to insulate a narrow class of public pension claimants from the risk of plan termination or modification. Of course, these capital market investors are more likely to have diversified portfolios, while public pension beneficiaries are likely to be wholly dependent on a single plan to provide benefits. But if a municipality is unable to access the bond market in the future because it is perceived as unfairly discriminating against capital market creditors in bankruptcy, then the city may need to steadily increase taxes to fund increasing pension obligations, thereby eroding the purchasing power of all residents, including pension beneficiaries.

For all of these reasons, a policy of always shoring up public pensions in Chapter 9 bankruptcy at the expense of other stakeholders may not be the best way for struggling municipalities to protect the broader economic interests of retirees *or* public sector employees. Robust, empirical research is needed to determine, for instance, whether cities may be able to avoid layoffs—both before and during a bankruptcy restructuring—and also

maintain competitive benefits for past, present *and* future employees if they were more confident of their abilities to exercise their rights to adjust pension obligations—and pension promises—in bankruptcy.

In the meantime, the *Stockton* court’s balanced inquiry provides a useful framework for determining whether and to what extent public pensions should be modified in bankruptcy. Recall that the court explained that something higher than the analogous “business judgment” standard ought to apply to a municipality’s rejection or unilateral modification of a public pension plan:

[R]ejection requires a finding that the policy of successful rehabilitation of debtors would be served by rejection. In making that finding, the court must balance the interests of the affected parties - debtors, creditors, employees - and must consider the consequences of the alternatives on the debtor, on the value of creditors' claims and any ensuing hardship and the impact on employees. The court also must consider the degree of hardship faced by each party and must consider any qualitative differences between the types of hardship each may face.<sup>219</sup>

But the case studies reveal that, for this exercise to be meaningful, courts must focus on the true “affected parties”—broad classes of creditors and employees—as opposed to merely considering the claims of those entities and organizations that have had an opportunity to engage in negotiations before and during the bankruptcy case. This is because the political economy of Chapter 9 deeply impacts restructuring outcomes, based on who is invited to the negotiation table and at what point in the proceedings. If courts are serious about assessing the needs and restructuring preferences of employees and retirees, the hardships faced by these and other constituencies, and the economic burdens that have been or will be allocated to them before, during, and after the bankruptcy, then some sort of direct polling mechanism may be more useful than simply hearing arguments made in court by the most powerful players. At a minimum, bankruptcy courts should take steps to ensure that official committees are formed at the commencement of the case, to represent, among other groups, retirees, employees, and taxpayers, and take steps to ensure that the court’s analyses focus on the needs and preferences of these groups rather than the needs and preferences of large contractual counterparties who have their own economic interests to advance. Finally, the contextual

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<sup>219</sup> Amended Opinion Regarding Confirmation and Status of CalPERS, *In re City of Stockton, California*, Case No. 12-32118 (Bankr. E.D.Cal. Feb. 27, 2015), at 47.

analysis should also take into account the role of future tax increases and/or reductions in city services, as well as any other forms of economic burden allocation contemplated by the plan.

As a supplement to the *Stockton* inquiry laid out above, courts and/or Congress should also consider developing more refined standards for rejecting and/or modifying public pensions in bankruptcy. For instance, a safe harbor could be applied to municipal debtors who (i) demonstrate that the plan of adjustment imposes pro rata cuts to all unsecured creditors, and (ii) promise to provide the same or greater amount of benefits that private pensioners would receive from the Pension Benefit Guaranty Corporation if their private pension plans failed.<sup>220</sup> The latter protection is especially important in cases where certain municipal employees are ineligible for Social Security and Medicare benefits.<sup>221</sup> In addition, courts and lawmakers may also consider some sort of individual means test, applied at the time of plan confirmation or at regular intervals to ensure that, above and beyond providing the baseline benefits described above, a municipality's limited resources are used to satisfy the additional claims of those who are most in need of benefits. By establishing a baseline amount of protection for all claimants as well as an individual means test for additional distributions, a safe harbor of this sort would allow for a more streamlined contract rejection or modification analysis, as courts would not be required to engage in the more thorough *Stockton* inquiry. Then, to the extent the plan must be crammed down, a similar inquiry could be used to assess whether the plan unfairly discriminates.<sup>222</sup>

As a final note, the legal developments highlighted in this Article suggest a need for more robust and meaningful disclosures by municipalities to employees who are promised public pensions and other future retirement benefits. In light of the recent judicial pronouncements that these benefits are subject to rejection or unilateral modification in bankruptcy, municipalities should fully inform employees of the legal and financial risks so that they can properly evaluate the value of the city's promise of deferred compensation. Such disclosures would enable employees to make informed career and financial decisions, while creating greater incentives for all stakeholders to hold a municipality accountable for its short- and longer-term fiscal choices. In this regard, the safe harbor

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<sup>220</sup> See *infra* notes 90 through 91, and accompanying text.

<sup>221</sup> See generally 42 U.S.C. §418.

<sup>222</sup> This essentially rejects the approach used by the Detroit court, or the mode of inquiry proposed in Dawson, *supra* note 215.

described above may help to better align economic incentives, as the municipal employees with the greatest control over fiscal decisions are also the most likely to receive the largest salaries and future pension benefits; given that their excess benefits may be reduced in bankruptcy, they may be more inclined to ensure that the municipality is meeting its annual pension obligations and otherwise engaging in sound fiscal management for the benefit of all beneficiaries and stakeholders.

#### IV. CONCLUSION

That recent large municipal bankruptcy cases have followed a prototype that deviates so much from legal rights probably says less about employee-centric policies and more about the political economy of Chapter 9. It also demonstrates the classic disconnect between the “law in the books” and the “law in action.”<sup>223</sup> **But the prototypical municipal bankruptcy restructuring may actually do more harm than good.** As courts continue to remind parties of the undisputed foundational principles of bankruptcy law, which rely primarily on legal rights to establish repayment priorities, they pave the way for reforms that not only better serve important public policy interests, but also ensure that essential safeguards in the Bankruptcy Code are able to function as the drafters intended. **This Article recommends a balanced and thoughtful legal framework for modifying public pension obligations in bankruptcy, with a built-in safe harbor that addresses important social policy concerns.** In so doing, it shifts power away from large and concentrated actors, giving a greater voice to the very stakeholders that the moral and equitable framework strives to protect.

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<sup>223</sup> The University of Wisconsin Law School has a rich history of “law in action” scholarship and teaching. *See, e.g.*, Paul D. Carrington & Erika King, *Law and the Wisconsin Idea*, 47 J. OF LEGAL ED. 297 (1997).