PENSIONS AND CHAPTER 9: CAN MUNICIPALITIES USE BANKRUPTCY TO SOLVE THEIR PENSION WOES?

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INTRODUCTION

As world markets and private industries struggle to recover from the financial collapse of the late 2000s, speculation has grown about the next wave of financial troubles. One area that has come under increasing scrutiny from experts and the media is the crippling debt loads of government entities. From local municipalities to sovereign nations, the risk of governments and governmental units defaulting on their debts is real and reflected in elevated rates of return for those willing to invest.[1] Rumors abound in the media that numerous United States cities and other municipalities[2] are on the brink of

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[1] *See, e.g.*, Tom Petruno, *Municipal Bond Yields Rise as Market Rally Stalls*, L.A. TIMES, Feb. 4, 2011, at B5 (reporting that the strained finances of many state and local governments has caused municipal bond yields to rise); Satyajit Das, *European Death Spiral—Communicable Diseases*, AUSTRALIAN BROADCASTING CORPORATION (Jan. 12, 2011), http://www.abc.net.au/unleashed/42864.html (reporting that the cost of funds for Portugal, Italy, Ireland, Greece, and Spain had risen to between 5 and 12% by the end of 2010).

[2] Throughout this Article, the terms "municipality" and "municipal" are intended to be interpreted consistent with the definition of "municipality" in Title 11 of the United States Code ("the Bankruptcy Code"). *See* 11 U.S.C. § 101(40) (2006) (defining a "municipality" as a "political subdivision or public agency or instrumentality of a State"). As more fully explained below at note 28, the Bankruptcy Code definition of "municipality" encompasses not just traditional cities, but also counties and certain other public agencies and authorities. This definition may be considerably broader than the commonly accepted meaning of the term "municipality." *See, e.g.*, *Municipality Definition*, MERRIAM-WEBSTER, http://www.merriam-webster.com/ dictionary/municipality (last visited Feb. 22, 2011) (defining "municipality" as "a primarily urban political unit having corporate status and usually powers of self-government").

defaulting on their obligations.[3] Faced with unsustainable and deepening budgetary shortfalls, municipalities are being forced to consider every option to extricate themselves from their difficult financial positions.[4]

The crisis among the nation's municipalities has many fathers, and every troubled municipality faces its own unique challenges.[5] Yet some common drivers can be identified. Not unlike private entities, municipalities across the nation have found themselves trapped in an extended cycle of declining revenues.[6] Plummeting real estate values and high rates of foreclosure have

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3 *See, e.g.*, Jeannette Neumann, *Global Finance: Warning From S&P on Munis*, WALL ST. J., Jan. 24, 2011, at C3 (reporting "growing fears that some state and local governments will default on their debt"); Sara Behunek, *Three American Cities on the Brink of Broke*, FORTUNE (May 28, 2010), http://money.cnn.com/2010/05/28/news/economy/american_cities_broke.fortune/index.htm (reporting on potential defaults by Detroit, Michigan; Harrisburg, Pennsylvania; and Jefferson County, Alabama); William Selway, *U.S. Mayors Say City Bond Defaults Likely Amid Strain*, BUS. WK. (Jan. 19, 2011), http://www.businessweek.com/news/2011-01-19/u-s-mayors-say-city-bond-defaults-likely-amid-strain.html (predicting the number of defaults among United States cities by the Chicago and Los Angeles mayors, along with banking analyst Meredith Whitney's forecast of as many as 100 significant municipal defaults).

4 The budgeted general-fund shortfalls among America's major cities are illustrative of the scale of the crisis. For example, for fiscal year 2011, Detroit projected a shortfall in its general fund of $126 million; Los Angeles projected a $492 million shortfall; and New York estimated a budget deficit of almost $5 billion. *See* THOMAS GINSBERG, PEW CHARITABLE TRUSTS, NOT OUT OF THE WOODS: THE RECESSION'S CONTINUING IMPACT ON BIG CITY TAXES, SERVICES AND PENSIONS 2 (Larry Eichel ed., 2010). For the same period, Chicago projected a shortfall of over $650 million in its general fund—nearly 20% of its proposed general fund budget. *See* Amy Merrick, *Chicago Projects Record Budget Shortfall*, WALL ST. J., Jul. 30, 2010, http://online.wsj.com/article/SB10001424052748703999304575399404117403866.html (reporting that the City of Chicago projected a 2011 deficit of $654.7 million after the city "plugged a $520 million gap" in its 2010 budget by mandating that employees take furlough days and dipping into city reserves).

5 Boise County, Idaho, for example recently filed its chapter 9 petition to allow it to continue operating notwithstanding an adverse judgment amounting to approximately 50% of the county's annual operating budget. *See* Stan Rosenberg, *Small Idaho County Files for Bankruptcy*, WALL ST. J., Mar. 3, 2011, http://online.wsj.com/article/SB10001424052748704005404576176841523443046.html. The City of Vallejo, California, which filed its chapter 9 petition in 2008, experienced plummeting property tax revenues with the departure of the United States Government's Mare Island shipyard in the midst of the housing crisis. *See* Jonathan R. Laing, *The $2 Trillion Hole*, BARRON'S (Mar. 15, 2010), http://online.barrons.com/article/SB126843815871861303.html#articleTabs_panel_article%3D1. In 2009, a declining population exacerbated by the closure of a military base caused the City of Prichard, Alabama to file its second chapter 9 petition in ten years. *See* Matt Miller, *Taboo: Chapter 9*, DEAL MAGAZINE (Mar. 19, 2010), http://www.thedeal.com/newsweekly/features/cover-stories/taboo:-chapter-9.php. Jefferson County, Alabama has been crippled by unfavorable swaps that it entered into to shield against rising interest rates on variable rate debt that financed a new sewer system. *See* Mary Williams Walsh & Jonathan Glater, *Contracts Now Seen as Being Rewritable*, N.Y. TIMES, Mar. 31, 2009, at B1. Meanwhile, the City of Harrisburg, Pennsylvania has been feeling the pinch since a local authority reneged on a $288 million debt for the purchase of an incinerator that the city guaranteed. *See* Romy Varghese, *Harrisburg Council Refuses to Meet Recovery Consultants*, WALL ST. J., Jan. 25, 2011, http://online.wsj.com/article/SB10001424052748704698004576104401574252370.html.

6 *See* Miller, *supra* note 5 (stating that "tax revenues from property, businesses[,] and retail sales [have] hit the skids").

eroded the property tax base, negatively impacting income.[7] Widespread unemployment and, in some cases, decreasing populations have depleted revenue from sales taxes and other forms of taxation.[8] In some cases, the shortfall in revenues is compounded by "out of the money" derivative transactions and tumbling markets, which have depleted many municipalities' cash positions.[9] Moreover, the cost to municipalities of issuing debt to replace this lost revenue is rising. The low interest rates traditionally enjoyed by large municipalities are becoming harder to find, whether because of the general "tightening" of the credit markets resulting from the financial crisis or because investors are beginning to take notice of the confluence of factors currently threatening municipalities.[10] Municipal debt traditionally was considered a relatively "risk-free" investment, but that has changed in the current market. Municipalities now find that their debt is the subject of an increasingly robust market in credit default swaps—one of the vehicles many claim was a leading culprit of the global financial crisis and the global sovereign-debt crisis.[11]

But perhaps the single largest problem facing municipalities today is the dramatic and growing shortfall in public pension funds. Considering only state pensions and those of municipalities participating in state funds, for example, the deficit is estimated by some to exceed $3 trillion nationwide[12] and may

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[7] *See* Eric Morath, *Restructuring Experts Predict U.S. Municipal Default*, WALL ST. J., May 17, 2010, http://blogs.wsj.com/bankruptcy/2010/05/17/restructuring-experts-predict-us-municipal-default (reporting that "[m]unicipalities are struggling in part because widespread foreclosures and commercial property vacancies have caused property values to fall, which in turn limits how much property tax local government can . . . collect[]").

[8] *See* Miller, *supra* note 5 (reporting that a declining population caused the City of Prichard, Alabama to file its chapter 9 petition).

[9] *See* Behunek, *supra* note 3 (reporting that Jefferson County, Alabama's financial difficulties stem in part from its purchase of billions of dollars in failed interest rate swaps); Leah Nathans Spiro & Nanette Byrnes, *Today, Orange County* . . ., BUS. WK., (Dec. 19, 1994), http://www.businessweek.com/archives/1994/b340434.arc.htm (reporting that the bankruptcy of Orange County was "the result of a confluence of sharply higher interest rates and an investment strategy that relied primarily on derivatives and enormous leverage").

[10] *See* Michael Corkery & Ianthe Jeanne Dugan, *New Hit to Strapped States—Borrowing Costs Up as Bond Flops; Refinancing Crunch Nears*, WALL ST. J., Jan. 14, 2011, at A1 (reporting on the elevated rates municipalities are being forced to pay to issue debt).

[11] *See id.*

[12] *See The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter: Hearing Before the Subcomm. on Courts, Commercial and Administrative Law of the H. Comm. on the Judiciary*, 112th Cong. 5 (2011) (statement of Joshua Rauh, Associate Professor of Finance, Kellogg School of Management, Northwestern University) ("Using valuation methods and accounting practices that are consistent with financial economics, . . . the already-promised part of these unfunded liabilities actually amounts to over $3 trillion"); PEW CENTER ON THE STATES, THE WIDENING GAP: THE GREAT RECESSION'S IMPACT ON STATE PENSION AND RETIREE HEALTH CARE COSTS 1–2 (2011) (estimating that unfunded state pension liabilities as of, in most cases, June 2009, were between $1.26 trillion and $2.4 trillion depending on the discount rate applied, an increase of 26% over the previous year). More

exceed $500 billion in California alone.[13] Unlike private pensions, public pensions generally are not regulated by federal law under the Employee Retirement Income Security Act of 1974 ("ERISA")[14] and, therefore, are not subject to the rigorous vesting and funding rules imposed by ERISA.[15] Similarly, public pension participants are not protected by the federal pension guarantee program operated by the Pension Benefit Guaranty Corporation ("the PBGC").[16] Thus, municipalities have far more freedom than private-sector employers to make their own choices about funding methods and policies (subject, of course, to governing state laws and fiduciary obligations).[17] The result has been several decades of increasingly rich benefits packages, often resulting from negotiations with a municipality's collective bargaining units, coupled with a less-than-rigid fiscal approach to paying for those benefits.[18] Politically, state and local officials have found it easier to make promises when times were good than to find ways to fulfill them in today's challenging economic climate.[19]

In many cases, public pensions are woefully under-funded. Public pension plans typically are considered to be adequately funded at the 80% level

recent data indicates that the average funding level of state pensions continued to fall in fiscal year 2010. *See id.* at 4 (reporting that, during fiscal year 2010, 10 of the 16 states reporting data sustained further declines in the funding level of their pensions).

13 Howard Bornstein et al., *Going for Broke: Reforming California's Public Employee Pension Systems*, SIEPR POLICY BRIEF (Stanford Institute for Economic Policy Research, Palo Alto, Cal.), Apr. 2010, at 1.

14 29 U.S.C. §§ 1001–1461 (2006).

15 *See id.* § 1003(b) (providing that "[t]he provisions of this subchapter shall not apply to any employee benefit plan if—(1) such plan is a governmental plan").

16 *See id.* § 1302(a) (stating that the purposes of the PBGC include "encourag[ing] the continuation and maintenance of *voluntary private pension plans* for the benefit of their participants" (emphasis added)).

17 One of the few areas where municipal pension plans are required to adhere to federal law concerns compliance with certain requirements of the Internal Revenue Code—including certain pre-ERISA funding requirements—for the pension plan to qualify for preferential tax treatment (that is, for plan contributions and investment earnings to be tax deferred for participants). *See* Mary A. Brauer, *State and Local Government Pensions: In What Circumstances Can Governments Reduce Pension Benefits?*, 20 BENEFITS L. J. 65, Winter 2007, at 65, 66 (discussing the limited application of certain provisions of the Internal Revenue Code to public pensions).

18 *See* Laing, *supra* note 5 (describing as "lush" the pensions that state and local public employees "have wangled from taxpayers").

19 *See* Phillip Reese, *The Public Eye: Pension Promises Threaten California Cities, Counties*, THE SACRAMENTO BEE (Apr. 11, 2010), http://www.sacbee.com/2010/04/11/2670020/pension-promises-threaten-california.html (describing the California Legislature's 1999 passage of augmented benefits for public safety officers, which caused municipalities to make the same promises to their employees); Paul Solman, *Promises, Promises: The Public Pension Pinch*, PBS NEWSHOUR, THE BUSINESS DESK (Jan. 17, 2011), http://www.pbs.org/newshour/businessdesk/2011/01/promises-promises-the-public-pension-pinch.html (discussing "[g]overnment pension overreach" and stating that pension benefits were "promised by government officials who figured they'd be long gone by the time the obligations came due").

because, ironically enough, public employers are assumed to be more financially stable than private corporations.[20] Prior to the recent market collapse, over three-fifths of state and municipal pensions were funded to at least this level.[21] As stocks tumbled and state and local revenues declined, however, this number fell to barely one-third.[22] By the end of 2009, the average public pension was 65% funded.[23] Moreover, by that time, the funding level of many major cities' pension funds had fallen far below even this mark.[24]

These funding shortfalls are further compounded in many cases by the unrealistically optimistic assumptions used to calculate funding status in the first place. Foremost among these may be the practice of applying an unduly high discount rate—historically, often 8% per annum—to the determination of whether the fund is adequate to meet its future obligations.[25] If more realistic (or at least more conservative) discount rates are used, the underfunding of public-pension plans becomes even more pronounced.[26] If municipalities are

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20 *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO 08-983T, STATE AND LOCAL GOVERNMENT PENSION PLANS: CURRENT STRUCTURE AND FUNDED STATUS 18 (2008).

21 *See id.* at 19–20.

22 *See* Gina Chon, *States Skip Pension Payments, Delay Day of Reckoning*, WALL ST. J., Apr. 9, 2010, at A5.

23 *See* Gina Chon, *Private Firm Pensions Face Costly Deadline—Businesses and Charities Seek an Extension on Funding Targets*, WALL ST. J., Apr. 1, 2010, at C3 (reporting that the average funding level for public pension plans was 65% as of the end of 2009).

24 *See, e.g.*, PEW CHARITABLE TRUSTS, *supra* note 4, at 3 (reporting that, as of the end of 2009, certain cities' pension funds were funded as follows: Atlanta (53.0% funded); Boston (59.3% funded); Chicago (42.7% funded); Philadelphia (45.0% funded); and Pittsburgh (34.3% funded)). Although its pension plan was funded at a more robust level of 89.7% as of the end of 2009, the City of Los Angeles faces a substantial budgetary shortfall of close to $500 million, and therefore is seeking to achieve savings through the modification of its pension plan. *Id.* Media reports indicate that, in many cases, the situation continues to deteriorate. *See, e.g.*, Kris Maher & Jeannette Neumann, *Pittsburgh Plays Pension Defense*, WALL ST. J., Feb. 5, 2011, at A3 (reporting that the City of Pittsburgh's pension is 29.5% funded); Jason Grotto, *What Happens If Chicago Pension Funds Run Out of Money?*, CHI. TRIB., Nov. 16, 2010, http://articles.chicagotribune.com/2010-11-16/news/ct-met-pensions-bankruptcy-20101116_1_firefighters-fund-pension-benefits-retirement-benefits (reporting that certain pension funds of the City of Chicago are less than 40% funded).

25 *See* Jonathan Barry Forman, *Funding Public Pension Plans*, 42 J. MARSHALL L. REV. 837, 863 (2008) (comparing the private sector's use of risk free rate or corporate bond rate to discount their liabilities to public pension sponsors' use of their own investment return assumptions of approximately 8%); *see also* Bornstein et al., *supra* note 13, at 5 (stating that California targets annual investment performance between 7.50% and 8.00%); *California's Public-Sector Pensions: Sanity in the Offing?*, THE ECONOMIST (Jun. 24, 2010), http://www.economist.com/node/16438779 (stating that the 1999 increase in public pension benefits passed in California relied their funding projections on assumptions that required the Dow Jones Industrial Average to hit 25,000 by 2009 and 28,000,000 by 2099).

26 Gina Chon, *Gurus Urge Bigger Pension Cushion*, WALL ST. J., Mar. 29, 2010, at A2 (stating that the discount rate applied to public pension funds is typically 8%, but lowering the discount rate by only one percentage point results in an increase of the total pension obligation by 10–20%).

going to solve their financial challenges, addressing these substantial pension liabilities in some fashion will be necessary.

Among the alternatives being widely discussed to address these mammoth liabilities is the dramatic step of filing a petition for relief under the historically little-used chapter 9 of the Bankruptcy Code.[27] Chapter 9 provides the option of federal bankruptcy relief to "municipalities," broadly defined to include any "political subdivision or public agency or instrumentality of a State."[28] Recognizing the limitations imposed by the Tenth Amendment of the United States Constitution,[29] access to chapter 9 must be authorized by the states.[30] Access to chapter 9 thus varies from state to state. For example, the State of

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[27] *See, e.g.*, Morath, *supra* note 7 (reporting the results of a survey conducted by AlixPartners LLP, which found that 90% of restructuring professionals predicted that "a significant American municipality will default on its debt before 2012").

[28] 11 U.S.C. § 101(40) (2006). Political subdivisions are entities that possess certain badges of sovereignty, including, for example, counties and cities. *See In re Las Vegas Monorail Co.*, 429 B.R. 770, 775 (Bankr. D. Nev. 2010) (holding that a nonprofit monorail operator was not a political subdivision "such as" a county or city). Examples of the sovereign characteristics held by political subdivisions include "the power to tax, the power of eminent domain[,] or the police power." *In re Cnty. of Orange*, 183 B.R. 594, 602 (Bankr. C.D. Cal. 1995) (holding that a county investment pool was not a political subdivision because it did not possess the characteristics of a sovereign).

Public agencies include authorities, commissions, or similar entities organized for the purpose of constructing, acquiring, or operating revenue-producing property. *See Cnty. of Orange*, 183 B.R. at 602. Public agencies may issue revenue bonds to finance their operations. *Id.* An entity is more likely to be a public agency if it is created expressly by statute. *Las Vegas Monorail*, 429 B.R. at 796 (holding that the monorail operator was not a public agency, in part, because it was "a creature of general nonprofit corporation laws rather than of a specific legislative enactment").

Finally, an instrumentality of a state under § 101(40) of the Bankruptcy Code is an entity that performs a public function under considerable state control. *See Las Vegas Monorail*, 429 B.R. at 789 ("If there is State control coupled with public function, then the nature and extent of that control determine whether the entity is an instrumentality."). The entity is an "instrumentality of a State" if it operates in place of the state rather than merely operating subject to regulations that ensure its decisions further the public good. *Id.* In determining whether an entity is an "instrumentality of a State" under the Bankruptcy Code, a court may consider whether the entity, among other things: (1) is funded from tax revenues; (2) does not compete functionally with other state entities; (3) possesses the power to issue obligations bearing tax-free interest; and (4) is considered to be an instrumentality of the state under state law. *See id.* at 789–800 (weighing these factors among others to determine whether the monorail operator is an instrumentality of the State of Nevada and ultimately holding that it is not).

In the future, relief for public entities under the Bankruptcy Code may not be limited to municipalities. A group of federal lawmakers led by former Speaker of the House and potential G.O.P. presidential candidate Newt Gingrich has recently proposed allowing sovereign states to seek bankruptcy protection (possibly through a new "chapter 8"). *See Gingrich Seeks Bill Allowing State Bankruptcy to Avert Bailouts*, PENSIONS & INVESTMENTS (Jan. 10, 2011), http://www.pionline.com/article/20110110/PRINTSUB/301109976 (reporting on the possible consequences on pension funds of state bankruptcy).

[29] 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.").

[30] *See* 11 U.S.C. § 109(c) (providing in part that "[a]n entity may be a debtor under chapter 9 of this title if and only if such entity . . . is specifically authorized . . . to be a debtor under such chapter by State law").

Georgia has opted out of chapter 9 altogether.[31] Other states, like California, have made access to chapter 9 widely available.[32] Many other states require special authorization for a chapter 9 filing.[33]

As a result, chapter 9 will not be available to all municipalities in all states. Even where it is available, chapter 9 does not provide municipalities with all of the bankruptcy tools that practitioners are familiar with in corporate bankruptcies under chapter 7 and chapter 11. Many of these limitations stem from the inability of a municipality to liquidate (as in a chapter 7 case) and the constitutional limitations of the federal bankruptcy court dictating the operation of a political subdivision of the state.[34] And, because chapter 9 has so rarely been used, there are many unanswered questions about what can and cannot be achieved in a chapter 9 case. Despite these limitations, chapter 9 offers a potentially powerful mechanism to assist municipalities in obtaining relief from creditors and adjusting their debts. As a result, from coast to coast,

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[31] Georgia law provides that:

> No county, municipality, school district, authority, division, instrumentality, political subdivision, or public body corporate created under the Constitution or laws of this state shall be authorized to file a petition for relief from payment of its debts as they mature or a petition for composition of its debts under any federal statute providing for such relief or composition or otherwise to take advantage of any federal statute providing for the adjustment of debts of political subdivisions and public agencies and instrumentalities.

GA. CODE ANN. § 36-80-5 (2010).

[32] *See, e.g.*, CAL. GOV'T CODE § 53760(a) (West 2003) (providing that "[e]xcept as otherwise provided by statute, a local public entity in this state may file a petition and exercise powers pursuant to applicable federal bankruptcy law"); N.Y. LOCAL FIN. LAW § 85.80 (McKinney 2009) (providing that "[a] municipality . . . may file any petition with any United States district court or court of bankruptcy under any provision of the laws of the United States, now or hereafter in effect, for the composition or adjustment of municipal indebtedness."). Since 2009, the California legislature has been considering proposed legislation to limit its broad grant of authority; however, that legislation has not passed as of the writing of this Article. *See* Bobby White, *California Cities Face Bankruptcy Curbs*, WALL ST. J., May 28, 2009, at A4 (reporting on the introduction of the proposed legislation that would require any California municipality to seek preauthorization from a state commission before filing chapter 9).

[33] *See, e.g.*, CONN. GEN. STAT. § 7-566 (2010) ("No municipality shall file a petition to become a debtor under [c]hapter 9 of Title 11 of the United States Code without the express prior written consent of the Governor."); KY. REV. STAT. ANN. § 66.400 (West 2010) ("No county shall file a petition as provided in the Federal Bankruptcy Act unless the proposed plan is first approved by the state local debt officer and the state local finance officer . . . ."); N.J. STAT. ANN. § 52:27–40 (West 2011) (providing that no municipality may file a petition under chapter 9 of the Bankruptcy Code "unless the approval of the municipal finance commission, which is hereby constituted a commission for the purposes of this article, be first had and obtained").

[34] *See* 6 COLLIER ON BANKRUPTCY ¶ 900.01[1] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) [hereinafter COLLIER] ("Because of the public nature of the entity experiencing financial difficulties, there is no provision in [chapter 9] for liquidation of its assets and distribution of the proceeds to creditors."); 5 WILLIAM L. NORTON, JR., NORTON BANKR. L. & PRAC. § 90:1 (William L. Norton, Jr. ed., 3d ed. 2008) ("[R]elief under [c]hapter 9 does not contemplate or permit liquidation of assets for the benefit of creditors.").

municipalities are examining the pros and cons of chapter 9 as an alternative of last resort.

The purpose of this Article is to identify certain tools and strategies offered by chapter 9 and to consider whether, individually or in unison, they may offer a real, workable solution to the overwhelming and seemingly unassailable pension obligations of many municipal debtors. While numerous commentators in the press have expressed optimism that chapter 9 provides municipalities with the means to address these obligations,[35] the reality is that this area of the law is largely untested in the courts, and very little is certain. To understand how municipalities' public-pension obligations may be addressed in a restructuring, this Article describes (I) the general framework of public pensions, (II) the relevant standards governing the modification or termination of public-pension plans under state law, and (III) the limited authority addressing legacy-pension issues in the context of a chapter 9 bankruptcy.

Although beyond the scope of this Article, the related commitments of municipalities to fund the future health care costs of retirees represent a problem that may be just as serious as the public-pension shortfall. In fact, because these commitments often have not been pre-funded at all (except on a pay-as-you-go basis), the problem may ultimately prove to be even more severe in some municipalities.

I. PUBLIC PENSION PLANS

A. Overview

The precise number of public-pension plans in the United States is not known. There are nearly 90,000 state and local governments in the United

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35 *See, e.g.*, Steven Greenhut, *Vallejo's Painful Lessons in Municipal Bankruptcy*, WALL ST. J., Mar. 27, 2010, at A13 (characterizing the City of Vallejo's failure to address its crippling pension obligations while a debtor in chapter 9 as setting a bad example and remarking, without further support, that bankruptcy is "probably the most effective tool in the drawer for lowering pension obligations"); ERIC MONTARTI, ALLEGHENY INST. FOR PUB. POL'Y, CHAPTER 9 BANKRUPTCY: WHAT IT MEANS FOR PENNSYLVANIA'S MUNICIPALITIES 9 (2009) (arguing without analysis that a bankruptcy judge could modify a public employer's pension benefits); Laing, *supra* note 5 (discussing the City of Vallejo, California's restructuring of its debt that included a three-year moratorium on principal and interest payments on $53 million of debt backed by its general fund, while the city declined to address its $84 million in pension-fund obligations); Miller, *supra* note 5 (assuming without further analysis that municipalities break their pension promises by filing bankruptcy petitions).

States, many of which offer pension benefits to their employees.[36] Many of these government employers are required by the terms of public-employee collective bargaining agreements to maintain separate pension plans or benefit tiers for different categories of employees—for example, teachers, police officers, and firefighters.[37] Notwithstanding the considerable number and variety of pension plans, however, several general observations can be made.

Municipal pensions are creatures of state and local law.[38] Federal law regulates public pensions only at the periphery. Neither ERISA nor the PBGC have any role in the creation, administration, modification, enforcement, or termination of public pension plans.[39] Moreover, federal law generally does not require municipal governments to maintain the funding or report on the funded status of their pension plans.[40] Municipalities may be authorized by state law to create and administer their own retirement systems and/or to participate in the system of the state at large. State or local laws establishing a public pension plan generally provide all of the details of the plan: who is covered by the plan, how the plan is to be funded (including the specific contribution amounts to be made by the employer and employee) and what

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36 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO 08-317, STATE AND LOCAL GOVERNMENTS: GROWING FISCAL CHALLENGES WILL EMERGE DURING THE NEXT 10 YEARS 6 (2008). Although there is no accurate measure of exactly how many municipalities currently sponsor public pension plans, the census bureau previously identified 2,547 state and local government employee retirement systems for the 2006–2007 period, covering 18,583,270 members, with 7,463,567 beneficiaries receiving periodic benefit payments. *See Table Five: Number and Membership of State and Local Public Employee-Retirement Systems by State: 2006–2007*, U.S. CENSUS BUREAU (Dec. 9, 2008), http://www.census.gov/govs/retire/2007ret05.html.

37 *See* Karen Eilers Lahey & T. Leigh Anenson, *Public Pension Liability: Why Reform is Necessary to Save the Retirement of State Employees*, 21 NOTRE DAME J.L. ETHICS & PUB. POL'Y 307, 309 (2007) ("State governments may . . . offer separate pension systems within the state for different kinds of employees.").

38 U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 20, at 5; *see also* Markman v. Cnty. of Los Angeles, 35 Cal. App. 3d 132, 134 (Cal. Ct. App. 1973) ("The terms and conditions relating to employment by a public agency are strictly controlled by statute or ordinance, rather than by ordinary contractual standards . . . ."); State *ex rel.* Gill v. Sch. Emps. Ret. Sys. of Ohio, 906 N.E.2d 415, 419 (Ohio 2009) (stating that school employees' retirement system and public employees' retirement system "as statutorily created entities . . . can pay benefits only as expressly authorized by statute").

39 *See* Lahey & Anenson, *supra* note 37, at 314 ("Unlike defined benefit plans offered by private companies, state government plans lack both oversight by the federal government and an insurance program to provide benefits if the plan fails.").

40 *See id.* (stating that, with respect to reporting by public pensions, "[w]hen and how liabilities are reported is subject to vagaries in each state"). *But see* Brauer, *supra* note 17 (discussing the limited funding requirements of the Internal Revenue Code). On February 9, 2011, however, proposed federal legislation known as the Public Employee Pension Transparency Act was introduced seeking to expand upon these reporting requirements by barring state and local governments from issuing tax-exempt bonds unless they provide annual reports to the U.S. Treasury on their pension plan liabilities. *See* Public Employee Pension Transparency Act, H.R. 567, 112th Cong. (2011); *see also* Sara Murray, *GOP Bill Takes Aim at Pension Disclosures*, WALL ST. J., Feb. 22, 2011, at A5 (reporting on the introduction of the bill).

benefits the plan provides. Typically, applicable law also identifies the entity that will be charged with administration of the plan and requires that pensions be managed as trust funds and overseen by boards.[41]

Beyond state and local statutes and regulations, membership in a collective-bargaining unit may affect a municipal employee's pension entitlement and obligations. For example, pursuant to the terms of collective bargaining agreements, public employers commonly agree to satisfy or "pick up" some or all of the required employee contribution, as permitted by law. In addition, collective bargaining agreements may prescribe an employee's wages or salary upon which the employee's retirement entitlement will be calculated.

The type of pension plan offered by most municipal plan sponsors is referred to as a defined-benefit-pension plan.[42] In a defined-benefit-pension plan, the plan sponsor promises the employee a monthly benefit that begins when the employee retires—determined by application of a formula at the time of retirement.[43] Although pension plans differ in their details, the general formula adopted by most plans entitles an employee, at retirement, to a predetermined monthly income for life (or the joint lives of the employee and spouse or other beneficiary) equal to a percentage of the employee's final or highest average salary, adjusted to reflect the number of years that the employee was employed.[44] This arrangement contrasts with the defined contribution plans popular outside the public sector, such as 401(k) and 403(b) plans, under which employees make tax-deferred contributions to their own account (sometimes matched in whole or in part by the employer) and direct the investment of that account over the course of their employment with the expectation that the funds in the account will be drawn down during retirement.[45]

The accounting rules applicable to public-pension plans are established by the Government Accounting Standards Board ("GASB"). Unlike the strict

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[41] *See* Lahey & Anenson, *supra*, note 37, at 310 (stating that defined benefit plans in the public sector are generally administered by a politically appointed trust-fund manager or a member-elected retirement board).

[42] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 20, at 8 (stating that, in addition to the defined benefit plan offered by most municipal plan sponsors, some form of supplemental defined contribution plan for voluntary savings also is offered).

[43] *See* Laing, *supra* note 5 (distinguishing defined benefit and defined contribution retirement plans).

[44] *See* JOHN R. CORNELL ET AL., A COLLIER MONOGRAPH: EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION IN CORPORATE BANKRUPTCY § 5[3][b][ii] (Alan N. Resnick & Henry J. Sommer eds., 2d ed. 2010) ("A defined benefit pension plan generally provides benefits according to a formula that takes into account an employee's compensation and/or service with an employer.").

[45] *See* Laing, *supra* note 5.

accounting rules of private-pension plans, established by the Financial Accounting Standards Board ("FASB"), GASB is much more flexible. For example, although GASB requires a municipal pension plan sponsor to issue reports that disclose information about plan assets, liabilities, funding status, and the assumptions used by the plan actuary, when and how this information is disclosed is left to the state, and not all states publish current data.[46] Moreover, because GASB allows public-pension plans to adopt different actuarial methods of determining plans' accrued liabilities, funding status, and other metrics, preparing a meaningful comparison of one public-pension plan to another is difficult.[47]

B. Pension Funding

When a municipal government promises a future payment to a worker, it creates a financial liability for its taxpayers.[48] When the worker retires, the municipality must make the benefit payments. To prepare for this, municipalities typically contribute to and, in some instances, manage their own pension funds to create large pools of money that are invested in stocks, bonds, and other financial instruments. In determining how much a plan sponsor must contribute to a plan each year, plan managers rely upon actuaries to make important assumptions regarding, among other things, the projected financial performance of the plan investments and the future profile of the work force, taking into account, for example, likely terminations, deaths, disabilities, wage growth, length of service, age of retirement, and life expectancy.[49] If the accrued liabilities of the plan exceed the actuarial value of the plan's assets, then the plan has a so-called "unfunded liability." Municipal plan sponsors may take various steps to reduce this unfunded liability going forward without requiring immediate additional employer contributions to the plan, including, among other things: (1) requiring higher contribution rates from employees; (2) issuing bonds to pay the unfunded liability; or (3) reducing the accruing liabilities by cutting the cost of benefits for new hires by adjusting benefit tiers within the plan or adopting entirely new plans with reduced benefits or defined contribution plans. Ultimately, however, if the plan does not have sufficient funds to fund pension benefits for current retirees, then the municipal plan

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[46] Lahey & Anenson, *supra* note 37, at 314. *But see* Public Employee Pension Transparency Act, H.R. 567, 112th Cong. (2011).

[47] Lahey & Anenson, *supra* note 37, at 314.

[48] *See* Editorial, *The Other Pension Crisis*, WALL ST. J., Aug. 18, 2006, at A14 ("Public pensions have only one source of money—the taxpayer.").

[49] *See* Forman, *supra* note 25, at 843.

sponsor will have to raise revenues, cut spending, or face a default on its obligations to retired employees.[50]

II. MODIFYING A PUBLIC EMPLOYER'S PENSION OBLIGATIONS OUTSIDE BANKRUPTCY

A. Background

As a general matter, modifying a public employer's pension obligations outside of bankruptcy is fraught with difficulties. First, pension benefits represent an item of utmost importance to large and influential unions and their public employee constituents. Accordingly, any attempt to terminate or reduce promised benefits can be expected to be met with significant resistance, potentially involving coordinated media campaigns, picket lines, and other methods of exerting political pressure. Even where non-union employees are affected, political pressure may make it difficult for public officials to modify existing pension obligations. Second, even if political pressure can be overcome, the law in many states considers public pension benefits to be constitutionally protected, which creates impediments to any cost-saving modifications to the applicable plans.[51] This constitutional protection is referred to as the "vested rights" doctrine. Thus, municipalities seeking to reduce or fully terminate retirement benefits outside of bankruptcy face daunting, potentially insurmountable obstacles.

As described above, public-pension plans are created by statute rather than by stand-alone plan documents.[52] As a result, to the extent a cash-strapped municipality determines that changes to a public-pension plan are needed, the most obvious solution would be for the appropriate governing body to pass new legislation amending or repealing the original statute, ordinance, or other regulatory scheme. In 1889, the United States Supreme Court opined that, with respect to active employees at least, there was no constitutional bar to this strategy.[53] According to the Court's holding in *Pennie v. Reis*, the modification of a public employee's entitlement to pension benefits is permissible because, until actual retirement, the employee possesses no contractual or absolute

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[50] *See* discussion of default by the City of Prichard, Alabama, *infra* Part III.A.

[51] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 20, at 12 (detailing the various states providing explicit constitutional protections for public pension benefits).

[52] *See supra* Section I.A.

[53] Pennie v. Reis, 132 U.S. 464, 471 (1889).

property interest in receiving pension benefits.[54] Under this "gratuity" theory, there is no constitutional impediment to the denial of the employee's "mere expectancy" of retirement benefits through amendatory legislation; rather, a municipality is at liberty to modify or terminate its pension obligations at will during employment.[55] Once retirement occurs, however, a constitutionally protected right arises.[56]

B. Development of the Vested-Rights Doctrine

Pennie has never been expressly overruled, and a number of states continue to subscribe to the position that public employees gain no vested rights to retirement benefits until they retire or are otherwise eligible to do so.[57] Although the rights of retirees likely are protected in these jurisdictions, there is no constitutional impediment to reducing, or even eliminating, the pension benefits of active employees who are not yet eligible to retire.

In many states, however, *Pennie* has been found to hail from a bygone era. From the latter half of the twentieth century onward, courts increasingly have come to the conclusion that *Pennie* is outdated and no longer binding. As one court explained: "The medieval or even colonial concepts of a compassionate and generous sovereign rewarding his humble, devoted subjects is completely

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[54] *See id.* (holding that a state's repeal of a police officer's entitlement to death benefits ten days before the officer's death "impaired no absolute right of property in the police officer" and infringed upon "no contract on the part of the state that its disposition should always continue as originally provided").

[55] *See id.* (stating that, prior to retirement, the employee's "interest in the fund was . . . a mere expectancy, created by the law, and liable to be revoked or destroyed by the same authority"); *see also* U.S. R.R. Ret. Bd. v. Fritz, 449 U.S. 166, 174 (1980) ("There is no claim here that Congress has taken property in violation of the Fifth Amendment, since railroad benefits, like Social Security benefits, are not contractual and may be altered or even eliminated at any time." (citing Hisquierdo v. Hisquierdo, 439 U.S. 572, 575 (1979) and Flemming v. Nestor, 363 U.S. 603, 608–11 (1960))).

[56] *See* Pennie, 132 U.S. at 471 (stating that the fund in issue was "entirely at the disposal of the government until, by the happening of one of the events stated, . . . the right to the specific sum promised became vested in the officer or his representative").

[57] *See, e.g.*, TEX. CONST. art. 16, § 66(d) (providing that "a change in service . . . of a retirement system may not reduce or otherwise impair benefits accrued by a person if the person . . . would have been eligible for those benefits, without accumulating additional service under the retirement system, on any date on or after the effective date of the change had the change not occurred"); Calvert v. City of Gadsden, 454 So. 2d 983, 984 (Ala. 1984) (holding that the municipality was free to modify employees' pension benefits until the employees had attained eligibility to retire); *accord.* Petras v. State Bd. of Pension Trs., 464 A.2d 894, 896 (Del. 1983); O'Connell v. State Dep't of Admin. Div. of Ret., 557 So.2d 609, 611 (Fla. Dist. Ct. App. 1990); Nicholas v. State, 992 P.2d 262, 265 (Nev. 2000) (stating that a public employee's rights to retirement benefits become constitutionally protected once the employee is eligible to retire); Taylor v. State & Educ. Emps. Grp. Ins. Program, 897 P.2d 275, 278–79 (Okla. 1995); Tait v. Freeman, 57 N.W.2d 520, 521–22 (S.D. 1953); *see also* Parker v. Wakelin, 123 F.3d 1, 9 (1st Cir. 1997) (holding that, under Maine law, public employees do not obtain a vested right to retirement benefits until they actually retire).

alien to our modern views of a democratic government's obligations to its citizens."[58] Accordingly, many state courts and legislatures developed theories to protect against the arbitrary revocation of retirement benefits during employment. Although these jurisdictions sometimes are referred to collectively as "vested-rights" jurisdictions, in reality, the theories underpinning these public-employee protections are far from uniform. The extent to which municipalities may pass legislation modifying the terms of their retirement plans depends greatly on the underlying theory of entitlement relied upon by the jurisdiction.

The majority of states that have moved away from *Pennie* protect the interests of public employees in retirement benefits under a theory that the employment relationship gives rise to an unassailable contractual right to receive a reasonable pension, consistent with the promises inherent in the statutory pension scheme. From the day they begin work, public employees in these jurisdictions are considered to possess a protected contractual right to retirement benefits. Consistent with this approach, the constitutions and statutes of no fewer than nine states expressly provide that membership in a public retirement system is a contractual relationship that may not be diminished or impaired.[59] In addition, courts in at least eight states have held

58 City of Frederick v. Quinn, 371 A.2d 724, 726 (Md. Ct. Spec. App. 1977).

59 *See* ALASKA CONST. art. XII, § 7 ("Membership in employee retirement systems of the State or its political subdivisions shall constitute a contractual relationship. Accrued benefits of these systems shall not be diminished or impaired."); ARIZ. CONST. art. XXIX, § 1 ("Membership in a public retirement system is a contractual relationship that is subject to Article II, section 25, and public retirement system benefits shall not be diminished or impaired."); HAW. CONST. art. XVI, § 2 ("Membership in any employees' retirement system of the State or any political subdivision thereof shall be a contractual relationship, the accrued benefits of which shall not be diminished or impaired."); ILL. CONST. art. XIII, § 5 ("Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."); LA. CONST. art. X, § 29 ("Membership in any retirement system of the state or of a political subdivision thereof shall be a contractual relationship between employee and employer, and the state shall guarantee benefits payable to a member of a state retirement system or retiree or to his lawful beneficiary upon his death."); MICH. CONST. art. IX, § 24 ("The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."); N.Y. CONST. art. V, § 7 ("After July first, nineteen hundred forty, membership in any pension or retirement system of the state or of a civil division thereof shall be a contractual relationship, the benefits of which shall not be diminished or impaired."); KY. REV. STAT. ANN. § 61.692 (West 2010) (providing that, except where a public employee is convicted of a felony, the employee's membership in the state retirement system shall "constitute an inviolable contract of the Commonwealth, and the benefits provided therein shall . . . not be subject to reduction or impairment by alteration, amendment, or repeal"); WIS. STAT. § 40.19 (2010) ("Rights exercised and benefits accrued to an employee under this chapter for service rendered shall be due as a contractual right and shall not be abrogated by any subsequent legislative act.").

that the beginning of the employment relationship (or initial participation in the public employer's pension system) creates a constitutionally protected contractual right to receive retirement benefits.[60] Often, this contractual right is deemed to become part of the employee's express or implied employment agreement.[61] The precise terms of any contract are not necessarily fixed from the commencement of employment, however, and may be subject to limited and reasonable modifications.[62]

Not all courts agree that vested rights arise from an implied-in-fact contractual relationship between the public employee and employer. One jurisdiction, for example, views public employment as creating an implied-in-law contract protected from revocation by principles of promissory estoppel.[63]

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[60] *See* Betts v. Bd. of Admin. of Pub. Emps.' Ret. Sys., 582 P.2d 614, 617 (Cal. 1978) ("A public employee's pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment."); Withers v. Register, 269 S.E.2d 431, 432–33 (Ga. 1980) (holding that public employees possess a contractual right to receive pension benefits if they (a) contribute any amount toward the benefits and (b) perform services for the employer while the law is in effect); Davis v. Mayor & Alderman of Annapolis, 635 A.2d 36, 40–41 (Md. Ct. Spec. App. 1994) (holding that because public employees may be "induced, at least in part, to their employment by the pension benefits held out at the time," employees should be entitled to substantially the program for which they bargained); Opinion of the Justices, 303 N.E.2d 320, 331 (Mass. 1973) (stating that the core expectations of members of public-retirement plans are constitutionally protected); Calabro v. City of Omaha, 531 N.W.2d 541, 551 (Neb. 1995) ("A public employee's constitutionally protected right in his or her pension vests upon the acceptance and commencement of employment . . . ."); Oregon State Police Officers' Ass'n v. State, 918 P.2d 765, 777 (Or. 1996) ("Once the employee performs services in reliance on the employer's promise to afford a particular benefit on retirement, the employer is contractually bound to honor that obligation."); Burlington Fire Fighters' Ass'n v. City of Burlington, 543 A.2d 686, 689 (Vt. 1988) ("[W]here an employee makes mandatory contributions to a pension plan, that pension plan becomes part of the employment contract as a form of deferred compensation, the right to which is vested upon the employee's making a contribution to the pension plan."); Bakenhus v. City of Seattle, 296 P.2d 536, 540 (Wash. 1956) (holding that a public employee holds a vested contractual right to retirement benefits from acceptance of employment); Dadisman v. Moore, 384 S.E.2d 816, 827 (W. Va. 1988) (holding that "retired and active" pension plan participants have contractually vested-property rights in their retirement benefits).

[61] *See* Duncan v. Retired Pub. Emps. of Alaska, Inc., 71 P.3d 882, 888 (Alaska 2003) (stating that promised retirement benefits at the time the employee is hired become part of the employee's contract of employment); *Burlington Firefighters' Ass'n*, 543 A.2d at 689 (stating that mandatory pension plans become part of the employee's contract of employment).

[62] California courts, for example, generally refer to an employee's right to a "substantial or reasonable" benefit, not an absolute immutable right. *See* Maffei v. Sacramento Cnty. Emps.' Ret. Sys., 127 Cal. Rptr. 2d 279, 284 (Cal. Ct. App. 2002) ("Under settled California law, the employee does not obtain, prior to retirement, any absolute right to fixed or specific benefits, but only to a substantial or reasonable pension." (internal quotation marks omitted)). Other jurisdictions articulate a similar general standard, albeit employing different language. *See, e.g.*, Madden v. Contributory Ret. Appeal Bd., 729 N.E.2d 1095, 1098 (Mass. 2000) ("[T]he government may not deprive members of the core of reasonable expectations that they had when they entered the retirement system." (citing Opinion of the Justices, 303 N.E.2d at 328)).

[63] *See* Christensen v. Minneapolis Mun. Emps. Ret. Bd., 331 N.W.2d 740, 749 (Minn. 1983) (reasoning that a promissory estoppel analysis was appropriate because "the state reasonably expects its promise of a

In addition, several states hold that a public employee's interest in retirement benefits rises only to the level of a property interest, protected by due process principles, unless the language of the applicable statute clearly evidences legislative intent to create a contractual relationship.[64]

C. *Modification Under the Vested-Rights Doctrine*

In general, unilateral efforts to diminish or terminate public-employee retirement benefits are prohibited in jurisdictions that have rejected the gratuity theory of benefit entitlement in favor of the vested-rights theory. Indeed, in vested-rights jurisdictions, the scope of permissible modifications generally is extremely limited and of little benefit to struggling municipalities.

In states that employ a contract-based analysis, legislative attempts to tamper with a public employee's implied contractual right to pension benefits typically are found to violate the Contracts Clause of the United States Constitution[65] and, in many instances, the parallel provision of the relevant state constitution as well.[66] Often, in contract-theory jurisdictions, the only modifications to a public employee's pension entitlement that do not violate these constitutional provisions are those that have, at worst, a neutral net impact on affected employees.[67] Under one widely adopted test—dubbed the

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retirement program to induce persons to accept and remain in public employment, and persons are so induced, and injustice can be avoided only by enforcement of that promise"); *accord* Law Enforcement Labor Servs., Inc. v. Cnty. of Mower, 483 N.W.2d 696, 701 (Minn. 1992).

64 *See* N.M. CONST. art. XX, § 22D ("Upon meeting the minimum service requirements of an applicable retirement plan[,] . . . a member of a plan shall acquire a vested property right with due process protections under the applicable provisions of the New Mexico and United States constitutions."); Spiller v. State, 627 A.2d 513, 517 n.12 (Me. 1993) (noting that, although public employees have no immutable contractual rights to retirement benefits, retirement expectations may constitute "property rights that the legislature cannot deprive them of without due process of law"); Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 197 A.2d 169, 175 (N.J. 1964) ("[T]he employee has a property interest in an existing fund which the State could not simply confiscate."); Pierce v. State, 910 P.2d 288, 305 (N.M. 1995) (holding that employees received due process before the legislative revocation of tax exemptions for state retirement benefits where public hearings were held prior to enactment of the legislation).

65 U.S. CONST. art. I, § 10 ("No state shall . . . pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.").

66 *See, e.g.*, Valdes v. Cory, 189 Cal. Rptr. 212, 226 (Cal. Ct. App. 1983) (holding that the decision by the board of the California state retirement system to suspend funding of the state's public employee pension plan violated the Contracts Clause of California's constitution); Unified Gov't of Athens-Clarke Cnty. v. McCrary, 635 S.E.2d 150, 151 (Ga. 2006) (stating that the impairment clause of the Georgia constitution "precludes the application of an amendatory statute or ordinance in the calculation of the employee's retirement benefits if the effect of the amendment is to reduce rather than increase the benefits payable") (quoting Withers v. Register, 269 S.E.2d 431, 432 (Ga. 1980))).

67 *See, e.g.*, *McCrary*, 635 S.E.2d at 151 (stating that any legislative change that reduces benefits payable offends Georgia's constitution); Denning v. Kansas Pub. Emps. Ret. Sys., 180 P.3d 564, 570 (Kan. 2008)

"California Rule"—a public employer may modify an employee's retirement benefits after the employee accepts employment only if the modifications bear a "'material relation to the theory of a pension system'" and the public employer provides comparable "offsetting advantages" to the employee.[68] The first element of the California Rule is not difficult to satisfy because changes made to "effect economies and save the employer money" or to advance "the ability of the employer to meet its pension obligations" have been found to "bear some material relation to the theory of a pension system and its successful operation."[69] With respect to comparable "offsetting advantages," however, the standard is more rigorous. Under this element, courts look to whether the *specific employees* affected by the modifications would tend to gain offsetting advantages from the proposed amendment.[70] In practice, any modification that is likely to pass this standard is unlikely to provide the public employer with substantial cost savings.

Notably, at least two contract-theory jurisdictions do not subscribe to the "California Rule." Courts in Pennsylvania and Tennessee employ a standard that may impose less stringent restrictions on the modification of public retirement benefits. These jurisdictions subscribe to the so-called "Pennsylvania Rule," which permits "reasonable modifications to a public employee retirement and pension plan when necessary to protect or enhance actuarial soundness of the plan, provided that no such modification can adversely affect an employee who has complied with all conditions necessary to be eligible for a retirement allowance."[71] Under this standard, a legislature

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(holding that reasonable modifications to a public employer's retirement system must, among other things, provide "'comparable new advantages'" to affected employees (quoting Brazelton v. Kansas Pub. Emps. Ret. Sys., 607 P.2d 510, 518 (Kan. 1980))).

[68] *See, e.g.*, *Denning*, 180 P.3d at 570 ("'[T]o be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.'" (quoting *Brazelton*, 609 P.2d at 518)); *accord* Duncan v. Retired Pub. Emps. of Alaska, Inc., 71 P.3d 882, 889 n.26 (Alaska 2003); Teachers' Ret. Bd. v. Genest, 65 Cal. Rptr. 3d 326, 344 (Cal. Ct. App. 2007); Davis v. Mayor & Alderman of Annapolis, 635 A.2d 36, 39 (Md. Ct. Spec. App. 1994); Dillon v. Beal (*In* re Estate of Dillon), 632 So.2d 1298, 1302 (Miss. 1994); Calabro v. City of Omaha, 531 N.W.2d 541, 551–52 (Neb. 1995); Retired Pub. Emps. Council of Washington v. Charles, 62 P.3d 470, 483 (Wash. 2003); Booth v. Sims, 456 S.E.2d 167, 185 (W. Va. 1994).

[69] Claypool v. Wilson, 6 Cal. Rptr. 2d. 77, 85–88 (Cal. Ct. App. 1992).

[70] *See* Abbott v. City of Los Angeles, 326 P.2d 484, 492 (Cal. 1958) ("[I]t is by advantage or disadvantage to the individual employees whose already earned and vested pension rights are involved that the validity of attempted changes in those rights depends . . . .").

[71] Knox Cnty. v. City of Knoxville, No. 736, 1987 WL 31640, at *12 (Tenn. Ct. App. Dec. 30, 1987); *see also* Pineman v. Oechslin, 488 A.2d 803, 808 (Conn. 1985) ("The second view allows those modifications to the retirement contract that reasonably enhance the actuarial soundness of the retirement fund.").

may make modifications that enhance the actuarial soundness of the plan—for example, increasing the minimum years of service or delaying the minimum retirement age—at any time until the employee has qualified to receive benefits under the plan.[72]

Just as in contract-theory jurisdictions, where a promissory-estoppel theory is utilized to protect a public employee's expectation of receiving retirement benefits, courts have held that modification of such implied-in-law contracts may violate the Contracts Clause of the United States Constitution and state equivalents.[73] In one case, however, the court reasoned that modifications may be permissible as an exercise of the state's police power, where the state can demonstrate a significant and legitimate public purpose behind the legislation and if "'the adjustment of the rights and responsibilities of the contracting parties is based upon reasonable conditions and is of a character appropriate to the public purpose justifying the legislation's adoption.'"[74] Applying this test, the court held that the city's attempt to strip a small number of former employees of their benefits had to yield to the reasonable expectations of the retirees, where there was no evidence that the integrity of the pension fund was in jeopardy.[75]

Where a jurisdiction views a public employee's retirement entitlement as more akin to a property interest, this property interest may be constitutionally protected from arbitrary revocation under the Takings and Due Process Clauses of the Fifth Amendment, the Due Process and Equal Protection Clauses of the Fourteenth Amendment, and state equivalents.[76] The precise

72 *See, e.g.*, Delaney v. City of Wilkes-Barre, 947 A.2d 854, 860 (Pa. Cmmw. Ct. 2008) ("An employe[e] who has not attained eligibility to receive a retirement allowance may be subject to legislation which changes the terms of the retirement contract if the change is a reasonable enhancement of the actuarial soundness of the retirement fund." (quoting Harvey v. Allegheny Cnty. Ret. Bd., 141 A.2d 197, 203 (Pa. 1958))).

73 *See* Christensen v. Minneapolis Mun. Emps. Ret. Bd., 331 N.W.2d 740, 749–50 (Minn. 1983) ("A promise enforced by estoppel, like a contract, contains an implied condition that the terms are subject to modification under the state's police power. . . . This exercise of the police power is, however, itself constrained by the federal and state constitutional prohibition against the passage of a law that impairs the obligations of contract.").

74 *Id.* at 751 (quoting Energy Reserves Grp., Inc. v. Kansas Power & Light Co., 459 U.S. 400, 412–13 (1983)).

75 *See id.* at 751–52.

76 *See* U.S. CONST. amend. V ("No person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."); U.S. CONST. amend. XIV ("[N]or shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."); *see also* State *ex rel.* Horvath v. State Teachers Ret. Bd., 697 N.E.2d 644, 648–53 (Ohio 1998) (evaluating legislation modifying the treatment of mandatory contributions to retirement system under constitutional Takings Clause and Equal Protection Clause); Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 197 A.2d 169, 175 (N.J.

scope of permissible modifications to public-pension laws in property-right jurisdictions is unclear. Nevertheless, relatively broad modifications appear to be possible in property-right jurisdictions, especially for the purpose of protecting the financial integrity of the pension plan (and thereby preserve the participants' property interests).[77]

In sum, many courts have moved away from the nineteenth century "gratuity" standard articulated in *Pennie* toward some version of a "vested rights" theory of public pension plan entitlement. In most of these jurisdictions, the governing rule is that these vested rights are contractual in nature and can be modified only to the extent affected employees are compensated with comparable offsetting advantages. Of course, each jurisdiction is unique and offers its own opportunities and challenges. In some cases, state law may allow for sufficient modifications of pension obligations to address the financial needs of a municipality. In many other cases, however, the tools available under state law simply will not permit sufficient changes to address a municipality's needs because the participating employees will be treated as having vested rights protected by the United States and state constitutions.

III. MODIFYING PENSION OBLIGATIONS IN CHAPTER 9

A municipality faced with a pension crisis and without an adequate state law remedy may look to bankruptcy as a potential solution. Of course, not all municipalities will even have access to bankruptcy courts under state law. Even where bankruptcy is an alternative, chapter 9 of the Bankruptcy Code probably does not provide a simple "silver bullet" that can, in a single shot, eradicate a struggling municipality's pension obligations. Chapter 9, however, does provide a debtor with a toolbox that is unavailable outside of bankruptcy. By using the available tools of chapter 9 in a coordinated manner, the bankruptcy process may provide a means of reducing the unfunded liability

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1964) ("[W]e think the employee has a property interest in an existing fund which the State could not simply confiscate."); Pierce v. State, 910 P.2d 288, 304 (N.M. 1995) ("Property rights are also protected under the [D]ue [P]rocess and [E]qual [P]rotection [C]lauses.").

[77] *See State ex rel. Horvath*, 697 N.E.2d at 651–53 (holding that legislation modifying the pension scheme by delaying the crediting of interest earned on mandatory contributions to retirement system until the employee's retirement (a) did not constitute an unconstitutional taking as to employees that died before retirement age, in part because employees did not have a reasonable investment-backed expectation that the law would not be changed; and (b) did not offend principles of equal protection, because a rational basis supported the state's disparate treatment of plan participants who met retirement eligibility and those who did not); *Spina*, 197 A.2d at 176 (holding that amendatory legislation extending public employees' required years of service by five years and delaying minimum retirement age by one year was not constitutionally void where the revision was necessary to protect the solvency of the fund).

portion of a municipality's pension obligation or otherwise compromising a municipality's pension debt. In this way, chapter 9 also may generate leverage for the municipality and pave the way for consensual modifications to its pension obligations. Four primary sections of the Bankruptcy Code provide a municipal debtor with tools to seek a reduction, modification, or compromise of its pension obligations: (A) the automatic stay of § 362;[78] (B) the power to assume and reject executory contracts, pursuant to § 365;[79] (C) the claims allowance process, pursuant to § 502;[80] and (D) the "plan of adjustment" process of § 943.[81] Ultimately, however, very little case law exists in this area. As a result, how effective these bankruptcy tools will be in addressing a municipality's pension debt is far from clear.

A. The Automatic Stay

The commencement of a bankruptcy case operates as a stay, applicable to all creditors, of most efforts to collect prepetition claims, including attempts to gain possession of property, enforce existing liens, impose new liens, or initiate or continue a lawsuit against the debtor.[82] The purpose of the stay is to provide the debtor time to reorganize or to liquidate in an orderly fashion without the constant threat of adverse creditor action. This protection of the automatic stay is often referred to as providing the debtor with a "breathing spell" to conduct the bankruptcy process for the benefit of stakeholders.[83] In the context of corporate reorganizations under chapter 11 of the Bankruptcy Code, debtors have invoked the automatic stay to shield themselves against claims arising out of missed prepetition contributions to private retirement plans.[84] With respect to postpetition required contributions, however, the

78 *See* 11 U.S.C. § 362 (2006).

79 *See id.* § 365.

80 *See id.* § 502.

81 *See id.* § 943.

82 *Id.* § 362(a).

83 *See* Alliance Capital Mgmt. L.P. v. Cnty. of Orange (*In re* Cnty. of Orange), 179 B.R. 185, 191 (Bankr. C.D. Cal. 1995) (listing the breathing spell provided by the automatic stay as one of two main benefits of chapter 9 for municipalities), *aff'd in part, rev'd in part, remanded*, 189 B.R. 499 (C.D. Cal. 1995).

84 *See, e.g.*, E. Air Lines, Inc., v. Rolleston (*In re* Ionosphere Clubs Inc.), 124 B.R. 635, 638–39 (S.D.N.Y. 1991) (holding that the prosecution of a state-court action violated the automatic stay where airline pilots asserted that a debtor airline converted employee benefit funds to its own use and sought to freeze $281 million of the debtor's assets and obtain an order requiring the debtor to make contributions); *In re* A & C Elec. Co., 188 B.R. 975, 981 (Bankr. N.D. Ill. 1995) (holding that the trustees of a union employee benefit plan violated the automatic stay by sending a letter to union employees threatening to suspend benefits if the debtor's prepetition contributions were not paid).

PBGC may be able to exert pressure on a private-sector debtor to make the payments.[85]

Chapter 9 incorporates and supplements the automatic stay of § 362 of the Bankruptcy Code through §§ 901(a) and 922.[86] Accordingly, while the automatic stay is in effect, a municipal debtor may assert that it cannot be compelled to honor its obligations to retirees.[87] In addition, the automatic stay

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85 *See* CORNELL ET AL., *supra* note 44, § 7[6][b] (stating that, where a chapter 11 debtor argues that it is not required to make postpetition contributions, the PBGC "may nonetheless threaten or initiate plan termination if the debtor fails to make these payments").

86 *See* 11 U.S.C. § 901(a) (incorporating § 362 of the Bankruptcy Code); *id.* § 922(a) (extending the automatic stay of § 362 of the Bankruptcy Code to, for example, "the commencement or continuation . . . of a . . . proceeding against an officer or inhabitant of the debtor that seeks to enforce a claim against the debtor").

87 As previously stated, pressure from the PBGC is not a consideration in a chapter 9 bankruptcy because the PBGC plays no role in regulating or insuring public pensions. *See supra* text accompanying note 39. However, a municipal debtor's failure to make postpetition pension contributions required by governing statutes would be contrary to applicable state law and, therefore, arguably a violation of Title 28 of the United States Code ("Judicial Code"). In particular, § 959 of the Judicial Code requires a "trustee, receiver[,] or manager appointed in any cause pending in any court of the United States, including a debtor in possession" to manage and operate the debtor's property in compliance with state law. 28 U.S.C. § 959(b) (2006). At first blush, it may appear that application of § 959 would require municipal debtors to comply with state laws that provide for the ongoing funding of their pension plans. Depending on the wording of the implicated legislation, § 959 arguably could even be employed in an effort to force the debtor to satisfy any prepetition unfunded liability. Yet attempts to invoke § 959 of the Judicial Code to municipal pension plan obligations in a chapter 9 case may gain little real traction due to the express wording of the statute. By its terms, § 959 is applicable only to trustees and court-appointed receivers or managers (including debtors-in-possession). *See id.* Consistent with the deference accorded states to manage their affairs found elsewhere in chapter 9 and as mandated by the Tenth Amendment of the United States Constitution, however, § 902(5) of the Bankruptcy Code expressly excludes the concept of a trustee and, by extension, a debtor in possession from chapter 9. *See* 11 U.S.C. § 902(5) (providing that "'trustee,' when used in a section that is made applicable in a case under this chapter by [§§] 103(e) or 901 of this title, means debtor, except as provided in [§] 926 of this title."). Accordingly, as a technical matter, chapter 9 debtors do not appear to be covered by the terms of § 959 of the Judicial Code. As a result, where a municipal debtor has discontinued contributions to its pension fund, § 959 may not provide public employees any relief.

Although this issue is largely untested, the applicability of § 959 recently was presented in the chapter 9 case of New York City Off-Track Betting Corporation. *See In re* New York City Off-Track Betting Corp., No. 09-17121 (Bankr. S.D.N.Y. Aug. 5, 2010) [hereinafter *In re NYOTB*]. In *In re NYOTB*, several horse-racing tracks moved to compel the chapter 9 debtor to comply with New York law requiring the payment of certain distributions pursuant to § 959 of the Judicial Code. *See* Motion of Empire Resorts, Inc. to Compel the Debtor to Comply With the Requirements of the New York Racing, Pari-Mutuel Wagering and Breeding Law and Make Certain Statutory Distributions, *In re NYOTB*, No. 09-17121 (Bankr. S.D.N.Y. Aug. 5, 2010) (No. 86); Motion of Finger Lakes Racing Ass'n, Inc. to Compel the Debtor to Immediately Pay Its Post-Petition Obligations, Comply With the Requirements of the New York Racing, Pari-Mutuel Wagering and Breeding Laws and Make Certain Statutory Distributions, *In re NYOTB*, No. 09-17121 (Bankr. S.D.N.Y. Aug. 5, 2010) (No. 90). In response, the debtor argued in part that, by its terms, § 959 of the Judicial Code is inapplicable to chapter 9 debtors. *See* Opposition of New York City Off-Track Betting Corp. to the Motions of Empire Resorts, Inc. and Finger Lakes Racing Ass'n, Inc., to Compel the Debtor to Comply With the Requirements of the New York Racing, Pari-Mutuel Wagering and Breeding Law and Make Certain Statutory Distributions, *NYOTB*, No. 09-17121 (Bankr. S.D.N.Y. Aug. 5, 2010) (No. 105) (utilizing an argument similar generally prevents contract counterparties from enforcing the terms of any contract against the debtor.[88] Accordingly, to the extent employees or retirees believe that they possess a contractual right to receive pension benefits, any such right is not enforceable against the debtor during the pendency of its chapter 9 case absent court relief. The bankruptcy court is empowered to lift the automatic stay in appropriate circumstances, and the pension plan administrator, retiree committee, creditors' committee, or other interested party may argue that sufficient "cause" exists to do so.[89] Nevertheless, the court, being mindful of the severe limitations placed on its power to direct the municipal debtor's use of its assets,[90] may not agree.[91] Even a temporary

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to the one articulated above). In an unpublished opinion, the court described the debtor's analysis of the applicability of § 959 in this regard as "highly technical." Memorandum Opinion and Order Denying in Part and Abstaining in Part to Motions to Compel the Debtor to Comply With the Requirements of the New York Racing, Pari-Mutuel Wagering and Breeding Law and Make Certain Statutory Distributions, *NYOTB*, No. 09-17121, at 19 (Bankr. S.D.N.Y. Aug. 5, 2010) (No. 138). Relying on the debtor's apparent acquiescence at oral argument that it was obliged to comply with state law, the bankruptcy court determined that it was "unnecessary for the [c]ourt to decide whether [§] 959 applies to chapter 9 cases." *Id.* at 20.

88 *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 532 (1984) (holding that the NLRB was precluded from enforcing the terms of a collective bargaining agreement against the debtor during the pendency of its chapter 11 case and stating that "the filing of the petition in bankruptcy means that the collective-bargaining agreement is no longer immediately enforceable, and may never be enforceable again."), *superseded in part by statute*, Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

89 Section 362(d) of the Bankruptcy Code (applicable in chapter 9 pursuant to § 922(b) of the Bankruptcy Code) provides that the bankruptcy court may grant relief from the automatic stay for "cause," among other reasons. *See* 11 U.S.C. § 362(d) (2006).

90 *See id.* § 904 (prohibiting bankruptcy courts from interfering with the debtor's political or governmental powers, property, or revenues, or the use or enjoyment of income-producing property, absent the debtor's consent or a provision to that effect in the debtor's plan of adjustment, which can be filed by no party other than the debtor under § 941 of the Bankruptcy Code); *see also supra* note 87 (discussing the possibility that a chapter 9 debtor is not one of the entities required by § 959 of the Judicial Code to manage and operate its property in compliance with state law).

91 There are, of course, various statutory exceptions to the automatic stay. In particular, § 362(b)(4) of the Bankruptcy Code provides that actions by governmental units to enforce their police or regulatory powers may be commenced or continued notwithstanding the automatic stay. *Id.* § 362(b)(4). The parties directly aggrieved—the employees and retirees—could not rely on this police powers exception to the automatic stay, however, which is available only to governmental units. *See* Diaz v. State (*In re* Gandy), 327 B.R. 796, 802 (Bankr. S.D. Tex. 2005) (confirming that only those actions brought by governmental units, as defined in § 101(27) of the Bankruptcy Code, may be excepted from the automatic stay under the police powers exception in § 362(b)(4) of the Bankruptcy Code). Nevertheless, a governmental unit (such as, for example, a department of the state government) could argue that this exception to the automatic stay permits it to pursue an action to compel a municipality in chapter 9 to satisfy its pension obligations. In this event, it is unlikely that the police powers exception would apply if the governmental unit were seeking merely to recover outstanding pension obligations on behalf of affected retirees because governmental actions with a pecuniary objective or a private purpose generally do not fall within the exception of § 362(b)(4) of the Bankruptcy Code. *See, e.g.*, Corporacion de Servicios Medicos Hospitalarios de Fajardo v. Mora (*In re* Corporacion de Servicios Medicos Hospitalarios de Fajardo), 805 F.2d 440, 446–47 (1st Cir. 1986) (holding that actions to enforce a governmental unit's contractual rights are not excepted from the automatic stay); *In re* Midway

suspension of pension contributions may provide significant leverage to a municipal debtor.

The suspension of pension plan payments was an issue in the chapter 9 bankruptcy case commenced by the City of Prichard, Alabama, in October 2009—its second in the past decade. Prichard's second case ("*Prichard II*")[92] ultimately was dismissed on the grounds that the City was no longer eligible to be a chapter 9 debtor because it had no outstanding funding or refunding bonds (a requirement of Alabama law to become a chapter 9 debtor).[93] Nevertheless, prior to dismissal, Prichard's inability to fund its pension plan was a primary issue in the case. Pursuant to the terms of the plan of adjustment confirmed in Prichard's prior chapter 9 case ("*Prichard I*"),[94] the City was required to make a $16.5 million cash infusion into its pension plan in October 2009.[95] The City did not make the payment, and the pension fund ran dry.[96] Facing a lawsuit from the pensioners,[97] the City filed a second chapter 9 petition. The City made no contributions to the pension fund or pension-benefit payments to its pensioners after filing its second chapter 9 petition.[98]

The City was successful, initially at least, in thwarting the pensioners' efforts to force the City to honor its pension obligations without modification.

Airlines Corp., 283 B.R. 846, 851 (E.D.N.C. 2002) (holding that an action by the state department of labor to enforce employee's prepetition wage claims was not excepted from the automatic stay). If the governmental action could be fairly characterized as an attempt by the state to pursue overall government policy, then an argument could be fashioned that the action falls within the police powers exception.

This argument has not been tested, and, in any event, it is not clear that a governmental unit would be empowered to or otherwise would pursue relief against a municipal debtor to enforce pension obligations. Accordingly, the police powers exception to the automatic stay likely would be of limited utility to public employees and retirees aggrieved by a chapter 9 debtor's failure to make pension plan payments.

92 *In re* City of Prichard, Ala. (*Prichard II*), No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009).

93 *See* Memorandum in Support of Motion to Dismiss Bankruptcy Case at 3–4, *Prichard II* (No. 193) (arguing that Alabama law permits only those municipalities with outstanding bond issuances to file chapter 9 and Prichard, having no outstanding bond issuances, was not so authorized). In deference to state sovereignty and to ensure compliance with the Tenth Amendment of the United States Constitution, a municipality may file chapter 9 only if authorized by its state to do so. *See supra* note 29.

94 *See In re* City of Prichard, Ala. (*Prichard I)*, No. 99-13465 (Bankr. S.D. Ala. Oct. 6, 2000).

95 *See* Complaint at 4, *attached as* Exhibit 1 to the Motion for Relief from Automatic Stay, *Prichard II* (No. 10) [hereinafter *Prichard Complaint*] (alleging in state-court complaint that, under the terms of its prior plan of adjustment, Prichard was required to make a cash infusion of $16.5 million into its pension plan beginning in October 2009).

96 *See* Michael Cooper & Mary Williams Walsh, *Alabama Town's Failed Pension Is a Warning*, N.Y. TIMES, Dec. 22, 2010, at A1 (stating that Prichard's pension fund ran dry).

97 Anders v. City of Prichard, No. 09-90150 (Mobile Cty., Ala. C.C.. 2009).

98 *See* Prichard Retirees' Motions for Administrative Expense Claim, & to Compel Payment of Administrative Expenses, at ¶ 13–15, *Prichard II* (No. 82) (alleging that the City made no pension payments since filing its chapter 9 petition).

The City's success was due, in substantial part, to the effect of the automatic stay imposed by the terms of §§ 362, 901, and 922 of the Bankruptcy Code. For example, the automatic stay prevented the pensioners from pursuing new litigation in the Alabama state courts regarding the City's decision to breach the terms of both the pension plan and the plan of adjustment approved in *Prichard I*. Similarly, the automatic stay prohibited the pensioners from prosecuting their preexisting lawsuit that sought, among other things, to hold certain of the City's officials (including the mayor) liable for negligence, breach of fiduciary duty, and other claims arising out of the poor financial performance of the City's pension fund.[99] In addition, the automatic stay required the retirees to assert their rights in the bankruptcy forum, which often is perceived as more "debtor friendly" because the court must consider not only the interests of the pensioners but also the wider interests of other creditors and the need to provide the debtor with a "fresh start." The pensioners' initial efforts before the bankruptcy court—a motion requesting relief from the automatic stay and a motion to compel the debtors to commence making contributions to the pension fund—failed.[100] The City's record of success came to an abrupt end, however, when the bankruptcy court granted the pensioners' motion to dismiss the chapter 9 case on the grounds that, under Alabama law, the City was not authorized to file its petition in the first place.[101] Ultimately, dismissal of Prichard's chapter 9 case may represent a hollow victory for the City's pensioners. Even though the City no longer is protected by the automatic stay, the depletion of the retirement fund and the extended absence of distributions has forced desperate pensioners to

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[99] *See Prichard Complaint*, *supra* note 95, at 8, 12 (alleging negligence against the City of Prichard and various officials). In chapter 9, the automatic stay is expanded to protect not only the municipal debtor, but also its officers and inhabitants—at least to the extent an action against such officers or inhabitants seeks to enforce a claim against the debtor. *See* 11 U.S.C. § 922(a) (2006) ("A petition filed under this chapter operates as a stay, in addition to the stay provided by [§] 362 of this title, applicable to all entities, of . . . the commencement or continuation . . . of a judicial, administrative, or other action or proceeding against an officer or inhabitant of the debtor that seeks to enforce a claim against the debtor . . . ."). In this way, the automatic stay in a chapter 9 case provides even greater protection from adverse creditor action than is provided in a chapter 7 or chapter 11 case.

[100] *See* Order Denying Without Prejudice Motion for Relief From Stay, *Prichard II* (Dec. 15, 2009); Order Denying Prichard Retirees' Motion for Administrative Claim and to Compel Payment of Administrative Expenses, *Prichard II* (No. 97).

[101] *See* Order Granting Motion to Dismiss Bankruptcy Case, *Prichard II* (No. 202). The City's appeal of the dismissal of its chapter 9 case remains pending before the district court as of the writing of this Article. *See* City of Prichard, Ala. v. Prichard Retirees, No. 1:10-cv-00622-KD-M (S.D. Ala. 2010) (appealing order granting motion to dismiss *Prichard II*).

compromise their claims, with many reportedly accepting a two-thirds reduction in future benefits.[102]

Similar issues arose in the chapter 9 case of *In re City of Vallejo, California* ("*Vallejo*").[103] In that case, the City unilaterally reduced its funding of retiree health benefits for some of its retired employees effective January 1, 2010.[104] Although retiree health benefits sometimes are more easily modified than pension rights, in California and other states they are protected as a vested contractual right like pension benefits.[105] As in *Prichard II*, the automatic stay blocked litigation in other tribunals and forced the retirees in *Vallejo* to bring their claims to the bankruptcy court. In particular, the official committee of retirees filed an adversary proceeding in the bankruptcy court seeking to restore health benefits to retirees.[106] The committee argued that the reduction in benefits violated the retirees' contractual, statutory, and constitutional

102 *See Prichard Retirees Would Receive 1/3 of Monthly Checks Under Pension Proposal*, AL.COM (Feb. 18, 2011), http://blog.al.com/live/2011/02/prichard_retirees_set_to_consi.html.

103 *In re* City of Vallejo, Cal., No. 08-26813 (Bankr. E.D. Cal. 2008).

104 *See* Complaint at 6, Official Unsecured Creditors' Comm. of City of Vallejo Retirees v. City of Vallejo, Cal. (*In re* City of Vallejo), Case No. 10-02136 (Bankr. E.D. Cal. May 6, 2010) (No. 1).

105 *See* Thorning v. Hollister Sch. Dist., 15 Cal. Rptr. 2d 91, 93–96 (Cal. Ct. App. 1992) (equating retiree medical benefits to pension benefits and holding that public employees possess a vested contractual right to retiree medical benefits); Duncan v. Retired Pub. Emps. of Alaska, Inc., 71 P.3d 882, 892 (Alaska 2003) (holding that a public employee's entitlement to retiree medical benefits vest on employment and may not be "diminished or impaired" under Alaska's constitution). *But see* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO 08-983T, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT STATUS OF BENEFIT STRUCTURES, PROTECTIONS, AND FISCAL OUTLOOK FOR FUNDING FUTURE COSTS 25 (2007) (recognizing that retiree health benefits generally enjoy significantly less protection from applicable state statutory and constitutional law).

Notably, the treatment of retiree medical benefits as a vested right appears to be losing ground to a judicial view that gives greater deference to the "well-founded presumption that a legislative body does not intend to bind itself contractually." San Diego Police Officers' Ass'n v. San Diego City Emps.' Ret. Sys., 568 F.3d 725, 739–40 (9th Cir. 2009) (citation omitted) (rejecting the reasoning of *Thorning* and holding that public employees possess no vested contractual right to retiree medical benefits); *accord* Studier v. Mich. Public Sch. Emps. Ret. Bd., 698 N.W.2d 350, 363–64 (Mich. 2005) (finding no vested contractual right to retiree medical benefits because of the strong presumption that statutes do not create contractual rights).

Moreover, in California, even under the *Thorning* view, the frequency with which modifications to retiree medical benefits have been found to be permissible suggests that the constitutional bar to modification may never have been as high as it is with respect to pension benefits. *See* Sappington v. Orange Unified Sch. Dist., 14 Cal. Rptr. 3d 764, 767–68 (Cal. Ct. App. 2004) (finding retiree health benefit modifications were permissible because the proposed modifications did not conflict with the terms of the promised benefits); Mayers v. Orange Unified Sch. Dist., No. G028330, 2003 WL 21489919, at *4–5 (Cal. Ct. App. June 30, 2003); Ventura Cnty. Retired Emps.' Ass'n v. Cnty. of Ventura, 279 Cal. Rptr. 676, 679 (Cal. Ct. App. 1991) (holding that a statute requiring agencies to give preference to medical plans that provide equal benefits to retirees did not require provision of equal benefits to retirees); Orange Cnty. Emps. Ass'n v. Cnty. of Orange, 285 Cal. Rptr. 799, 804–06 (Cal. Ct. App. 1991).

106 *See* Complaint, *supra* note 104, at 1.

rights.[107] The City responded by moving to dismiss on several grounds, including on the bases that (1) the committee lacked standing to bring the proceeding; and (2) the retirees had no vested right to receive the health benefits because they arose under a collective bargaining agreement of limited duration.[108] On August 11, 2010, the court entered an order granting the City's motion to dismiss.[109] One month later, the parties stipulated to a dismissal of the retirees' appeal without further elaboration.[110] Ultimately, while it is possible the City will be forced to honor the retiree health benefits at some point, the automatic stay of § 362 of the Bankruptcy Code allowed the City to reduce protected health benefits, temporarily at least, and provided the City with significant leverage over its retirees during these proceedings.[111]

Both the *Pritchard II* and *Vallejo* cases demonstrate how the automatic stay may be used by a municipal debtor to take actions with respect to its retirees that otherwise would not be possible outside of chapter 9. Notably, in *Prichard II*, the pressure exerted on beneficiaries by the City's failure to make pension contributions was amplified by the fact that the fund had been depleted, causing the plan to be administered on a pay-as-you-go basis.[112] Consequently, despite eventually prevailing in their bid to dismiss the chapter 9 case, the delays inherent in the process and the protection afforded by the automatic stay forced the retirees to return to the negotiating table.[113] Had the City been permitted to continue adjusting its debts in chapter 9, the impact on pensioners

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[107] *See* Memorandum of Points & Authorities in Support of City's Motion to Dismiss First Amended Complaint, at 5, *In re City of Vallejo*, No. 08-26813 (Bankr. E.D. Cal. May 6, 2010) (No. 19).

[108] *See id.* at 17–27.

[109] *See* August 11, 2010 Civil Minute Order Granting the Motion to Dismiss, *In re City of Vallejo*, No. 08-26813 (Bankr. E.D. Cal. May 6, 2010) (No. 51).

[110] *See* Order Dismissing Appeal, *In re City of Vallejo*, No. 08-26813 (Bankr. E.D. Cal. May 6, 2010) (No. 66).

[111] In a chapter 11 case, § 1114 of the Bankruptcy Code typically restricts a debtor's power to modify retiree health benefits unless a specified process is followed and stringent standards are met. *See* 11 U.S.C. § 1114(f)(1)(A) (2006) (requiring that the trustee, or debtor-in-possession, make a proposal for necessary modifications to the authorized representative of the retirees that includes assurances that the retirees are treated fairly and equitably with other creditors and the debtor); *id.* § 1114(f)(1)(B) (requiring the trustee or debtor-in-possession to provide all necessary information to support its proposal); *id.* § 1114(g) (requiring the bankruptcy court to enter an order modifying retiree benefits if the court finds that the retiree representative refused without good cause to accept a proposal containing necessary modifications that treats all parties fairly and equitably and "is clearly favored by the balance of the equities"). A municipal debtor under chapter 9 of the Bankruptcy Code enjoys greater freedom to reduce retiree health benefits because § 1114 of the Bankruptcy Code is not incorporated into chapter 9. *See id.* § 901(a) (omitting § 1114 of the Bankruptcy Code from incorporation into chapter 9).

[112] *See* Cooper & Walsh, *supra* note 96 (describing the substantial consequences for pensioners of the City's failure to make pension distributions).

[113] *See id.* (reporting that mediation of the retirees claims is expected).

may have been even greater. Likewise, whatever the ultimate outcome of the adversary proceeding in *Vallejo*, it is clear that, by reducing retiree benefits, the City placed substantial pressure on the retirees to reach a resolution as quickly as possible—a significant source of leverage that the City may not have been able to access outside of bankruptcy.

Thus, relying on the automatic stay, chapter 9 debtors have exerted substantial pressure on retirees to negotiate over a reduction in benefits. In other situations, however, the impact of the automatic stay may be more muted. Where money remains in the pension fund for distribution, for example, retirees may not immediately feel the effect of the municipality's failure to replenish the fund. Consequently, retirees may be less willing to compromise their entitlements so long as they continue to receive pension payments from what remains in the fund.

In addition, practical considerations may cast doubt on the wisdom of using the automatic stay to withhold pension contributions with respect to *active* employees. The continued functioning of the municipality depends, in large part, on the goodwill of its current employees and their willingness to continue providing services and labor in exchange for benefits. Unilateral action by a municipal employer against its active employees to cease or reduce required pension contributions could be a risky proposition and may invite considerable labor upheaval, as well as political repercussions for elected decision-makers. Moreover, as discussed in greater detail below, to the extent the frozen benefits relate to postpetition services, they likely constitute an administrative claim, pursuant to § 503 of the Bankruptcy Code, and will have to be paid in full regardless. Finally, the protections of the automatic stay exist only for so long as the municipality remains in bankruptcy and, absent a consensual modification of a municipality's pension plan or other adjustment of the obligations in bankruptcy, the automatic stay likely will provide the municipality with only a delay in honoring its obligations to the extent employees' and retirees' entitlements are deemed to have "vested." Other sections of the Bankruptcy Code, however, may provide the chapter 9 debtor with additional tools to address these issues.

B. Assumption and Rejection of Executory Contracts

Section 365 of the Bankruptcy Code, which governs the treatment of "executory contracts" and "unexpired leases" in bankruptcy, applies in chapter

9.[114] Generally, § 365 permits a debtor to either (a) assume (i.e., affirm or ratify) executory contracts and unexpired leases that it wishes to maintain and fulfill or sell or (b) reject (i.e., disavow) executory contracts and unexpired leases that it no longer wishes to maintain. Thus, if a municipal debtor determines that an executory contract or unexpired lease is burdensome, § 365 of the Bankruptcy Code provides the debtor with the power to reject it upon approval of the bankruptcy court. Rejecting contracts is one of the core bankruptcy powers. It is a particularly powerful tool because rejection is treated as a prepetition breach of the agreement, and the claim arising from this breach is treated as a general unsecured prepetition claim that is subject to compromise in bankruptcy.[115] Further, as a court authorized breach, the debtor generally is freed from future performance under the rejected contract.[116]

Not all contracts are eligible for rejection under § 365 of the Bankruptcy Code. Rather, § 365 applies only to contracts that are "executory" in nature. In determining whether a particular contract is executory, courts historically have followed variations on the so-called Countryman Test, which looks to whether "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[117] A minority of courts, however, treats the Countryman Test as helpful but not controlling, employing instead a "Functional Approach" which looks to whether rejection of the contract would benefit the debtor's estate.[118] If

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[114] *See* 11 U.S.C. § 901(a) (incorporating § 365 of the Bankruptcy Code).

[115] *See id.* § 365(g)(1) ("[T]he rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease . . . immediately before the date of the filing of the petition . . . .").

[116] *See* Penn Traffic Co. v. COR Route 5 Co. (*In re* Penn Traffic Co.), No. 05 Civ. 3755, 2005 WL 2276879, at *4 (S.D.N.Y. Sept. 16, 2005) ("Rejection of an executory contract relieves the debtor of the duty to perform its obligations under the contract, and is 'vital to the basic purpose [of] a [c]hapter 11 reorganization.'" (quoting NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) (alteration in original))), *superseded in part by statute*, Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984)).

[117] Vern Countryman, *Executory Contracts in Bankruptcy* (pt. 1), 57 MINN. L. REV. 439, 460 (1973); *see also Bildisco*, 465 U.S. at 522 n.6 ("The Bankruptcy Code furnishes no express definition of an executory contract, but the legislative history of § 365(a) indicates that Congress intended the term to mean a contract on which performance remains due to some extent on both sides." (citations omitted)).

[118] The Functional Approach has been employed in numerous jurisdictions, but it appears to be most consistently invoked by courts from within the Sixth and Eleventh Circuits. *See* Thompkins v. Lil' Joe Records, Inc., 476 F.3d 1294, 1305 n.13 (11th Cir. 2007) (stating that the Eleventh Circuit Court of Appeals has tacitly approved of the Functional Approach); Sipes v. Atlantic Gulf Cmtys. Corp. (*In re* Gen. Dev. Corp.), 84 F.3d 1364, 1374 (11th Cir. 1996) ("'Even though there may be material obligations outstanding on the part of only one of the parties to the contract, it may nevertheless be deemed executory under the functional approach if its assumptional rejection would ultimately benefit the estate and its creditors.'" (quoting Arrow

beneficial, the agreement is considered to be executory and, as a result, subject to assumption or rejection under § 365 of the Bankruptcy Code. Whatever test is employed to determine which contracts are "executory," a debtor's determination to reject such agreements is typically examined under a relatively deferential "business judgment" standard.[119] If there is a sound basis for a debtor to reject a contract in its business judgment, courts typically will approve the rejection.[120]

One area where the chapter 9 debtor may have its chapter 11 counterpart at an advantage is in its augmented power to reject collective bargaining agreements. Specifically, § 1113 of the Bankruptcy Code requires a chapter 11 debtor to follow special procedures before it may reject a collective bargaining agreement, but § 1113 of the Bankruptcy Code does not apply in a chapter 9 case.[121] Accordingly, a collective bargaining agreement should be easier to reject in a chapter 9 case than in cases under chapter 11 of the Bankruptcy Code. In *Bildisco*, however, the United States Supreme Court imposed certain requirements on a debtor seeking to reject a collective bargaining agreement, including reasonable efforts by the debtor to resolve the contract issues prior to rejection and a consideration of the hardships of the rejection on employees.[122] Although § 1113 of the Bankruptcy Code does not apply to chapter 9 debtors,

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Air, Inc. v. Port Auth. (*In re* Arrow Air, Inc.), 60 B.R. 117, 122 (S.D. Fla. 1986))); Phar-Mor, Inc. v. Strouss Bldg. Assocs., 204 B.R. 948, 952 (N.D. Ohio 1997) ("A court may find a contract is executory under the functional approach, even though it might not have found the contract to be executory under the Countryman test."); *see also* Shoppers World Cmty. Center, L.P. v. Bradlees Stores, Inc. (*In re* Bradlees Stores, Inc.), No. 01-CV-3934, 2001 WL 1112308, at *7 (S.D.N.Y. Sept. 20, 2001) (remarking that the Second Circuit has not expressly adopted either the Countryman definition of, or the Functional Approach toward, executory contracts, causing courts within the Second Circuit to employ either or both standards). Since there is no bankruptcy "estate" in a chapter 9 case, presumably the use of the Functional Approach in chapter 9 would focus on the benefit to the debtor (rather than the benefit to the debtor's estate). *See, e.g.*, 11 U.S.C. § 901(a) (not incorporating into chapter 9 the provisions of § 541 of the Bankruptcy Code, which provides for the creation of a bankruptcy estate); *id.* § 902(1) ("'[P]roperty of the estate,' when used in a section that is made applicable in a case under this chapter [9] by [§§] 103(e) or 901 of this title, means property of the debtor . . . .").

119 *See* 3 COLLIER, *supra* note 34, ¶ 365.03[2] ("[M]ost courts have applied a 'business judgment' test to trustees' decisions to assume or reject contracts or leases.").

120 *See id.* ("[T]he court should focus on the business judgment of the trustee or debtor in possession, not on its own business judgment.").

121 *See* 11 U.S.C. § 901(a) (omitting § 1113 from incorporation into chapter 9).

122 The *Bildisco* case predated the enactment of § 1113 of the Bankruptcy Code and established the standard for the rejection of collective bargaining agreements under § 365 of the Bankruptcy Code. The three-part test articulated in *Bildisco* requires a showing that: (a) the labor agreement burdens the estate; (b) after careful scrutiny, the equities balance in favor of contract rejection; and (c) "reasonable efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution." *Bildisco*, 465 U.S. at 526.

the *Bildisco* requirements (which call for a balancing of the equities rather than a strict business judgment test) would apply.

Two decisions by California courts provide some indication of the consequences of Congress's decision not to incorporate § 1113 into chapter 9. In *In re County of Orange*, a coalition of county employee organizations sued the municipal debtor to enforce their labor contracts and sought an emergency injunction preventing the debtor from conducting permanent layoffs.[123] The debtor argued that it was entitled to make unilateral changes to its collective bargaining agreements under *Bildisco* because § 1113 is inapplicable in chapter 9 cases.[124] The employee organizations countered that the debtor should be required to satisfy the strict standard for emergency modification of labor contracts provided for by California law, consistent with the balance of power between the federal government and the states embodied in §§ 903 and 904 of the Bankruptcy Code.[125]

The bankruptcy court granted the injunction and held that, although the *Bildisco* standard applied to rejection of the collective bargaining agreements, the debtor also should be required to satisfy the standard of California law "if not as a legal matter, certainly from an equitable standpoint."[126] The court agreed with the employee organizations that chapter 9 recognizes the delicate balance between state and federal interests and stated that, even under *Bildisco*, municipalities must view unilateral modification of their labor contracts as a last resort.[127]

In *In re City of Vallejo* ("*Vallejo*"), the municipal debtor moved to reject its collective bargaining agreements less than one month after filing its petition for relief under chapter 9 of the Bankruptcy Code.[128] Consistent with *In re County of Orange*, the court held that § 1113 was inapplicable to a chapter 9 debtor's rejection of collective bargaining agreements and that the *Bildisco* standard should govern.[129] The *Vallejo* court was less deferential to California state labor laws than the *In re County of Orange* court, however. The court held that § 903 of the Bankruptcy Code permits states to "act as gatekeepers to

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[123] Orange Cnty. Emps. Ass'n v. Cnty. of Orange (*In re* Cnty. of Orange), 179 B.R. 177, 179 (Bankr. C.D. Cal. 1995).

[124] *Id.* at 181.

[125] *Id.* at 181–82.

[126] *Id.* at 184.

[127] *Id.* at 184–85.

[128] *In re* City of Vallejo, 403 B.R. 72, 74 (Bankr. E.D. Cal. 2009), *aff'd*, Int'l Bhd. of Elec. Workers, Local 2376 v. City of Vallejo (*In re* City of Vallejo), 432 B.R. 262 (E.D. Cal. 2010).

[129] *Id.* at 78.

their municipalities' access to relief under the Bankruptcy Code."[130] When a state authorizes its municipalities to file for relief under the Bankruptcy Code, the court emphasized, "it declares that the benefits of chapter 9 are more important than state control over its municipalities."[131] This means that any state authorizing access to chapter 9 "must accept chapter 9 in its totality."[132] Consequently, if a municipality is authorized by the state to file a petition under chapter 9 of the Bankruptcy Code, it "is entitled to fully utilize 11 U.S.C. § 365 to accept or reject its executory contracts."[133] Further, the bankruptcy court noted that, although no California law purported to impose pre-filing restrictions on a municipal debtor requiring it to comply with state labor laws, any such attempted limitation on § 365 would be preempted pursuant to the Supremacy Clause and the Contracts Clause of the United States Constitution.[134]

Having outlined the standard for rejection, the court stopped short of addressing the merits of the debtor's motion.[135] Instead, the court deferred ruling "to give the parties every opportunity" to reach a settlement.[136] Despite the clear shift of leverage that the initial ruling provided from the unions to the debtor, one of the unions was unable to come to terms with the debtor. Approximately five months after its initial decision on the matter, the court authorized rejection of the remaining collective bargaining agreement.[137]

Consistent with the *Vallejo* decisions, a municipal debtor may use the rejection power to address burdensome pension-related obligations contained in collective bargaining agreements. For example, where a municipality has burdensome "pick-ups" under collective bargaining agreements, rejection of the collective bargaining agreement will release the municipality from the obligation to contribute employee shares to the pension fund. Moreover, rejection of a collective bargaining agreement permits the renegotiation of salaries fixed therein. Any reduction in salary will, in turn, reduce the municipality's future pension liability that is calculated with reference to the

130 *Id.* at 76.
131 *Id.*
132 *Id.* (quoting Cnty. of Orange v. Merrill Lynch & Co. (*In re* Cnty. of Orange), 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996)).
133 *Id.*
134 *Id.* at 76–77.
135 *See id.* at 78.
136 *Id.*
137 *See* Order Authorizing Rejection of Collective Bargaining Agreement Between Debtor and International Brotherhood of Electrical Workers, Local 2376, *In re City of Vallejo*, 403 B.R. at 72 (No. 526).

salaries. Indeed, despite not directly addressing its pension obligations in chapter 9, *Vallejo* received this indirect benefit by rejecting the collective bargaining agreement.[138]

The enhanced ability to reject collective bargaining agreements in chapter 9 may significantly shift the balance of power to the municipal debtor. Although not explicitly discussed in the *Vallejo* decision, this enhanced negotiating position can assist directly or indirectly in addressing a municipality's pension obligations to the extent that they are governed or affected by a collective bargaining agreement. However, a municipality also must weigh the risks of pursuing rejection. The rejection of a collective bargaining agreement—if actually achieved—will have a direct impact on current employees. Just as with the possibility of using the automatic stay to withhold benefits contributions, rejection of collective bargaining agreements can be expected to result in significant upheaval among affected employees and to strain relations with the unions representing the affected bargaining units.

Beyond retirement benefits established by collective bargaining agreements, the application and utility of § 365 to public-pension obligations is less clear. In most cases, there will not be any traditional written pension contract for a debtor to reject because public-pension obligations typically arise out of state statutes, local ordinances, or similar laws. Absent an executory contract of some sort, § 365 is inapplicable.

Yet even without a traditional written agreement, statutory pension obligations arguably may be treated as contracts, either in their own right or as integral parts of employment agreements. In jurisdictions adopting the contract theory of pensions, an implied contractual right is precisely what courts have found to create employees' vested pension rights in the first place. In these jurisdictions, a deemed or implied contractual relationship (created by the statutory scheme) underpins state employees' "vested rights" to their retirement benefits because this implied contract cannot constitutionally be impaired.[139] Although the treatment of this implied contract has not been tested in chapter 9, plan beneficiaries arguably should not obtain the benefits of the "contract theory" for vesting purposes without also being subject to the statutory provisions relating to the treatment of contracts in bankruptcy. In

[138] *See* Michael Corkery, *Chapter 9 Weighed in Pension Woes*, WALL ST. J., Dec. 23, 2010, at C1 (reporting that the City of Vallejo succeeded in indirectly lowering its pension obligations by the reducing salaries through the rejection of its collective bargaining agreements).

[139] *See supra* Part II.B–C.

other words, if the sole impediment to modifying pension benefits outside of bankruptcy is the deemed existence of a contract, then that contract should be eligible for rejection under § 365 to the extent it is executory.[140] Under the majority Countryman Test, an argument could be made that this deemed contract is indeed executory—with respect to active employees, at least—on the grounds that material obligations remain mutually unperformed between an employer and its current employees. Under the Functional Approach, this argument could potentially be extended to include all situations where rejection of the contractual relationship is beneficial to the municipal debtor, including with respect to retirees who no longer are required to perform future services to obtain benefits.[141]

Where the entitlement to retirement benefits is deemed to become part of an express or implied employment agreement, then the debtor cannot reject the former without the latter.[142] Of course, any such mass rejection of employment agreements could have a significant impact on the workforce. Nevertheless, the potential for rejection of the employment agreements and the pension entitlements that accompany them may provide the debtor with substantial leverage to negotiate or establish new employment terms. To the extent the contractual rights exist independently of any employment agreement, the effect of rejecting the notional contract supporting employees' entitlements to retirement benefits is not completely clear. Presumably, a debtor would argue that any such rejection—like the rejection of other contracts—eliminates the debtor's obligation to fund future pension obligations for employees (and perhaps retirees) as of the petition date and turns any damage claims into prepetition claims subject to compromise (to the extent the liabilities are not already funded). In this way, a debtor would argue that the rejection power under § 365 preempts state statutory or constitutional restrictions on reducing retirement benefits. Although this argument is untested in the public pension context, the preemptive force of the federal bankruptcy power of rejection

140 There is no requirement that executory contracts subject to rejection must be written or express. *See* 1 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 1:5 (4th ed. 2007) (stating that the legal effect of express and implied-in-fact contracts is identical and that "the distinction is based on the way in which mutual assent is manifested.").

141 Notwithstanding this possibility, the rejection of any implied contract between a municipal debtor and its retirees might be of lesser importance in the chapter 9 context. As discussed in greater detail below, a strong argument can be made that the claims of retirees should be treated as prepetition liabilities of the debtor that are subject to compromise in bankruptcy. If that is the case, rejection of retiree pension agreements (and the resulting rejection damage claims) would not provide any incremental benefit to the debtor.

142 *See* 3 COLLIER, *supra* note 34, ¶ 365.03[3] ("An executory contract may not be assumed in part and rejected in part. The trustee must either assume the entire contract, *cum onere*, or reject the entire contract, shedding obligations as well as benefits." (footnotes omitted)).

should not be underestimated. In situations where a debtor attempts to reject a contract that is protected by state law, courts generally hold that the state law is preempted. As the court reasoned in *Vallejo*, "state labor law applicable outside of the bankruptcy context, and the contracts clause of the California Constitution, Article I, Section 9, do not apply to the City's rejection of its collective bargaining agreements because they conflict with [§] 365 and the Bankruptcy Code. They are preempted."[143]

The preemptive effect of § 365 over potentially conflicting state laws has been recognized in other contexts. For example, in the recent chapter 11 cases of Chrysler LLC and its affiliated debtors, the debtors moved to reject agreements with 789 of their dealerships.[144] Outside of bankruptcy, each of the dealership agreements was protected by applicable state laws imposing conditions and financial burdens on the termination of the agreements.[145] The dealers argued, in part, that the debtors should be prohibited from rejecting the dealership agreements unless they also complied with the state dealer laws.[146] The bankruptcy court disagreed. Quoting *Vallejo*, the court held that the provisions of the state dealer laws were preempted to the extent that they would impede the debtors' ability to make full use of § 365.[147] Moreover, since rejecting the dealership agreements, the debtors and the new owner of the Chrysler business have successfully fended off several post hoc attempts by states to pass legislation purporting to reinstate certain dealership rights under the rejected agreements.

Although many of these arguments remain theoretical for now, or at least untested, a chapter 9 debtor has the ability to pursue potentially powerful relief under § 365 where pension obligations arise under collective bargaining agreements or other written agreements, or arise by virtue of an implied statutory contract. In these situations, employees and retirees hold most of the cards outside of chapter 9, but the filing of a bankruptcy petition could shift the

143 *In re* City of Vallejo, 403 B.R. 72, 77 (Bankr. E.D. Cal. 2009), *aff'd*, Int'l Bhd. of Elec. Workers, Local 2376 v. City of Vallejo (*In re* City of Vallejo), 432 B.R. 262 (E.D. Cal. 2010); *see also Int'l Bhd. of Elec. Workers*, 432 B.R. at 268 ("[A] state's authorization that its municipalities may seek [c]hapter 9 relief is a declaration of state policy that the benefits of [c]hapter 9 take precedence over control of its municipalities."); Cnty. of Orange v. Merrill Lynch & Co. (*In re* Cnty. of Orange), 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996) ("By authorizing the use of chapter 9 by its municipalities, California must accept chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest.").

144 *See In re* Old Carco LLC, 406 B.R. 180, 186–87 (Bankr. S.D.N.Y. 2009).

145 *See id.* at 199 (stating that the dealer statutes set forth "[r]ights includ[ing] statutory waiting and notice periods for wind-downs and buy-back requirements for terminations with or without cause.").

146 *See id.*

147 *See id.* at 205–06.

balance of power significantly. If nothing else, the inherent uncertainty of the situation may be used to bring the necessary parties to the bargaining table. And where bargaining is unsuccessful or cannot on its own modify “vested” state rights, the debtor may have the ability to seek relief from the bankruptcy court.

In addition, any damages resulting from the rejection of a “contractual” pension right would still have to be established and addressed as described below. To what extent that claim can be compromised will depend on the ultimate outcome of the chapter 9 case.

C. The Claims Allowance Process

Chapter 5 of the Bankruptcy Code provides the basic framework for the allowance and disallowance of claims in bankruptcy.[148] Beginning with the filing of a proof of claim or request for payment, the claims allowance process ultimately results in the determination of the validity, amount, and priority of all claims asserted against a debtor. Section 901(a) of the Bankruptcy Code incorporates much of this process into chapter 9 cases, including § 501 (filing of proofs of claim and interests), §502 (allowance of claims or interests), 503 (allowance of administrative claims), and § 507 (priorities among claims).[149] Importantly, however, certain key aspects of the claims allowance process are not applicable in chapter 9, and other provisions relating to equity and other “interests” simply have no application with respect to a municipality. Nonetheless, because much of the process available to a chapter 11 debtor has been incorporated into chapter 9, a municipal debtor may benefit from some of the same procedural and substantive techniques used by chapter 11 debtors to fix, and in some cases reduce, their prepetition pension liability. The claims allowance process is not, by itself, a method of reducing liability. Rather, it represents a tool that, when combined with other provisions of the Bankruptcy Code, may assist the debtor in its overall strategy to address its pension liabilities and increase its negotiating leverage with respect to its pension obligations.

One core aspect of the claims process is to distinguish between priority and nonpriority claims. Once a claim is recognized as a priority claim, the claimant is entitled to receive full payment of the claim in any chapter 9 case or

148 *See* 11 U.S.C. §§ 501–11 (2006).

149 *See id.* § 901(a) (incorporating certain sections of chapter 5 of the Bankruptcy Code into chapter 9 practice).

chapter 11 reorganization.[150] In contrast, classification as a general unsecured, nonpriority claim shifts the leverage back to the debtor because such claims may be subject to significant impairment, including in connection with the "cram down" process in a nonconsensual plan of adjustment, described in greater detail below.[151] As previously discussed, one of the significant benefits of rejecting a pension-related executory contract is that (1) the rejection is deemed a breach as of the petition date and (2) any resulting future damage claims caused by this breach are treated as prepetition, unsecured nonpriority claims.[152] These rejection damage claims then can be compromised with other general unsecured claims. Any pension-related claims that improperly assert a priority status may be reclassified by the bankruptcy court on request of the debtor.[153]

Certain prepetition claims are entitled to priority in chapter 7 or 11 bankruptcy. Notably, most types of prepetition claims that would be entitled to priority against a corporate debtor under chapter 11 are *not* entitled to priority against a municipal debtor. Chapter 9, for example, disregards nine categories of claims entitled to priority under § 507 of the Bankruptcy Code.[154] Among the types of claims denied priority status in chapter 9 is the fifth priority given under other chapters of the Bankruptcy Code to certain contributions to an employee benefit plan arising from services rendered during the 180 days prior to the petition date.[155] Accordingly, any liability of a chapter 9 debtor arising

150 *See, e.g.*, *id.* § 1129(a)(9)(A) (requiring administrative claims to receive full payment, in cash, on the effective date of any chapter 11 plan); *id.* § 943(b)(5) (same with respect to chapter 9 plan). With respect to prepetition priority claims under § 507(a)(1) to (8) of the Bankruptcy Code, § 1129(a)(9) also requires any approved plan to pay these claimants in full, either as of the effective date of the plan or over time. *See id.* § 1129(a)(9). As more fully explained below, however, chapter 9 of the Bankruptcy Code denies priority status to all claims that enjoy priority under other chapters of the Bankruptcy Code with the sole exception of administrative expenses under § 503(b) and other claims afforded priority under § 507(a)(2) of the Bankruptcy Code. *See infra* note 155.

151 *See infra* Part III.D.

152 *See supra* Part III.B.

153 *See* 11 U.S.C. § 502(b)(1) (excepting from allowable claims those claims that are "unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured").

154 *See id.* § 901(a) (omitting, with the exception of § 507(a)(2) relating to postpetition administrative expenses, all priority provisions of § 507(a) of the Bankruptcy Code from incorporation into chapter 9).

155 *See id.* § 507(a)(5) (granting fifth priority status to up to $11,725 per covered employee in "allowed unsecured claims for contributions to an employee benefit plan . . . arising from services rendered within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first"). Chapter 9 also excludes the fourth priority status otherwise granted to certain unpaid prepetition wages earned within 180 days before the petition date—an additional potential diminution of rights of active employees in the event of a chapter 9 filing. *See id.* § 507(a)(4) (granting fourth priority status to certain wages, salaries, and commissions over the same period).

from prepetition underfunding of a benefit plan is not entitled to priority. If a pension plan participant seeks a priority for this type of claim, the debtor has the power to object.[156]

As to a municipal debtor's *postpetition* obligations to its pension participants, chapter 9 incorporates § 503, providing for the allowance of certain administrative expenses, and § 507(a)(2), which accords priority to administrative expenses allowed under § 503(b).[157] Administrative expenses typically include the costs of administering the bankruptcy cases and may include the value of goods and services received by the debtor postpetition in the operation of the municipality. In chapter 9, as in chapter 11, wages and benefits earned after the petition date are entitled to administrative expense priority and generally will have to be paid in full.[158] To qualify as an administrative expense, postpetition obligations under prepetition agreements must satisfy the test first articulated by the First Circuit Court of Appeals in *In re Mammoth Mart, Inc*.[159] Under *Mammoth Mart*, a claim is entitled to administrative expense priority only if both (1) the claim arises out of a transaction with the estate and (2) the consideration supporting the claimant's right to payment was both supplied, and beneficial, to the debtor-in-possession or trustee in the operation of the business.[160] Applying the *Mammoth Mart* test,

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156 *See id.* § 502(a) (providing that claims are "deemed allowed, unless a party in interest . . . objects").

157 *See id.* § 901(a) ("Sections . . . 503 [and] 507(a)(2) . . . of this title apply in a case under this chapter.").

158 *See id.* (incorporating, among others, § 507(a)(2) of the Bankruptcy Code, which provides priority status to administrative claims arising under § 503(b) of the Bankruptcy Code); *see also id.* § 503(b)(1)(A)(i) (according administrative priority for postpetition wages and benefits).

159 Cramer v. Mammoth Mart, Inc. (*In re* Mammoth Mart, Inc.), 536 F.2d 950 (1st Cir. 1976), *superseded by statute*, 11 U.S.C. § 1113, *as recognized in In re* Colo. Springs Symphony Orchestra Ass'n, 308 B.R. 508 (Bankr. D. Colo. 2004).

160 More specifically, the *Mammoth Mart, Inc.* court stated as follows:

> For a claim in its entirety to be entitled to first priority under § 64(a)(1), the debt must arise from a transaction with the debtor-in-possession. When the claim is based upon a contract between the debtor and the claimant, the case law teaches that a creditor's right to payment will be afforded first priority only to the extent that the consideration supporting the claimant's right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business. When third parties are induced to supply goods or services to the debtor-in-possession pursuant to a contract that has not been rejected, the purposes of § 64(a)(1) plainly require that their claims be afforded priority. It is equally clear that a claimant who fully performs under a contract prior to the filing of the petition will not be entitled to first priority even though his services may have resulted in a direct benefit to the bankrupt estate after the filing. Similarly, even when there has technically been performance by the contract creditor during the reorganization period, he will not be entitled to § 64(a)(1) priority if the bankrupt estate was not benefitted in fact therefrom.

Id. at 954 (footnote and citation omitted). The court's citation to § 64(a)(1) refers to the Bankruptcy Act, which was in effect at the time of this ruling.

a chapter 9 debtor's postpetition obligations to its retirees arising out of prepetition contractual (or impliedly contractual) relationships arguably are entitled to nothing more than general unsecured nonpriority status and may be impaired in a plan of adjustment.[161] Likewise, employees' claims arguably would be entitled to priority only to the extent that they relate to postpetition services provided to the debtor.

These claim-priority issues were addressed in *Prichard II*. In particular, on February 12, 2010, certain of the City's retirees filed a motion seeking to require the debtor to make pension contributions as required by the City's pension plan and the confirmation order in its prior chapter 9 bankruptcy case, *Prichard I*.[162] The City failed to make one monthly payment into the fund immediately prior to filing its second chapter 9 petition in October 2009, and all subsequent payments after the filing of its chapter 9 case.[163] The retirees sought to compel the City to pay, on an administrative priority basis, every payment that it had missed since the petition date and all future payments throughout the pendency of the City's chapter 9 case.[164] The retirees asserted that the City was obligated to make these payments under § 503(b)(1)(A) of the Bankruptcy Code, which provides that "there shall be allowed, administrative expenses, . . . including . . . the actual, necessary costs[,] and expenses of preserving the estate."[165] Subsection (i) of § 503(b)(1)(A) further provides that "wages, salaries[,] and commissions for services rendered after the commencement of the case" are specifically entitled to administrative priority.[166]

In its response, the City argued that its obligations to the retirees were not entitled to administrative expense priority under the *Mammoth Mart* test because (1) the consideration received for the retirees' claims was provided prior to the petition date and (2) the obligation to make the pension payments

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As noted earlier, there is no bankruptcy estate in a chapter 9 case, nor is there a trustee or debtor in possession. *See supra* note 87. To apply *Mammoth Mart*, to a chapter 9 debtor, one approach would be to distinguish more generally between the prepetition debtor and the postpetition debtor. In this formulation of the test, administrative priority would be granted to (1) claims arising out of transactions with the postpetition debtor (rather than the estate) where (2) the consideration supporting the claim was supplied to and beneficial to the postpetition debtor (rather than the debtor-in-possession). This appears to be the approach argued in *Prichard II*, as discussed below.

161 *See infra* Part III.D.

162 Prichard Administrative Expense Motion, *supra* note 98, at 4.

163 *See id.* at 3.

164 *Id.* at 4.

165 *Id.* at 3–4; *see also* 11 U.S.C. § 503(b) (2006).

166 11 U.S.C. § 503(b)(1)(A)(i).

arose out of contractual commitments made before the chapter 9 debtor came into existence.[167] The City further argued that the bankruptcy court was prohibited from directing the city to make the payments under § 904 of the Bankruptcy Code, which disallows court interference with "(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property."[168] Two days after the city filed its response, the bankruptcy court entered an order denying the retirees' administrative expense request pursuant to findings of fact and conclusions of law that it had made on the record.[169] The court did not issue an opinion with respect to its order. In light of this decision, *Prichard II* provides support for the proposition that any pension benefit earned prior to the petition date, and potentially any other obligation earned under a prepetition agreement, is entitled to no more than general unsecured, nonpriority treatment.

Certain procedural mechanisms in the claims allowance process also can help a municipal debtor address its pension obligations. Section 924 of the Bankruptcy Code requires municipal debtors to file a list of known creditors and the amount of the applicable claim owed to each creditor (the "Scheduled Creditor List"), similar to the schedules of liabilities in a chapter 11 case.[170] In addition to these "scheduled" claims, the debtor may ask the court to establish a deadline (a so-called bar date) by which all claimants must file a proof of claim, setting forth the asserted amount and bases of their claims if they disagree with the scheduled claims.[171] A proof of claim is deemed filed on behalf of each creditor that appears on the Scheduled Creditor List in the amount stated, provided that this amount is not listed as disputed, contingent, or unliquidated.[172] But creditors holding claims listed as disputed, contingent, or unliquidated—or who disagree with the amount or classification of their

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[167] Memorandum of Law in Support of City of Prichard's Responses to Retirees' Motions for Administrative Claim, to Compel Payment of Administrative Expenses and to Compel Debtor to File a Plan of Reorganization, at 3, *In re* City of Prichard, Ala. (*Prichard II*), No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009) (No. 93).

[168] 11 U.S.C. § 904; *see also* Prichard Response, *supra* note 167, at 3–4.

[169] Order Denying Prichard Retirees' Motion for Administrative Claim and to Compel Payment of Administrative Expenses, at 1, *In re* City of Prichard, Ala. (*Prichard II*), No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009) (No. 97).

[170] *See* 11 U.S.C. § 924 (providing that the "debtor shall file a list of creditors").

[171] *See* FED. R. BANKR. P. 3003(c) (providing in part that the "court shall fix and for cause shown may extend the time within which proofs of claim or interest may be filed").

[172] *See* 11 U.S.C. § 925 ("A proof of claim is deemed filed under [§] 501 of this title for any claim that appears in the list filed under [§] 924 of this title, except a claim that is listed as disputed, contingent, or unliquidated.").

claims on the Scheduled Creditor List—must file a proof of claim by the bar date established by the court.

The bar date mechanism is widely used in chapter 11 and chapter 7 cases, but is available in chapter 9 as well. Establishing a bar date provides the debtor with (1) a clear picture of its overall asserted liabilities, as well as the basis for such liability; and (2) a fixed date, beyond which no new claims may be asserted against the debtor on account of prepetition liability. If a claimant fails to file a proof of claim by the established deadline, the claim may be forever barred from being asserted in the future (absent limited extenuating circumstances).[173] If this occurs, the amount of the claim is limited to the undisputed, liquidated amount declared by the debtor in its Scheduled Creditor List.[174] Although courts sometimes permit the filing of single proofs of claim on behalf of entire classes of individuals,[175] where the filing of a class claim is not permitted, the onus is on each individual claimant to protect its own rights.

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173 *See id.* A claimant may be permitted to file a proof of claim after the bar date in appropriate circumstances. Rule 9006(b) of the Federal Rules of Bankruptcy Procedure allows a party to move for the extension of any deadline established under the Bankruptcy Rules or by order of the court after its expiration where the failure to meet the deadline was the result of "excusable neglect." FED. R. BANKR. P. 9006(b). Courts employ the equitable test outlined by the Supreme Court in *Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. P'ship*, 507 U.S. 380 (1993), to determine whether "excusable neglect" exists. In *Pioneer*, the Court stated that:

> Because Congress has provided no other guideposts for determining what sorts of neglect will be considered "excusable," we conclude that the determination is at bottom an equitable one, taking account of all relevant circumstances surrounding the party's omission. These include, as the Court of Appeals found, the danger of prejudice to the debtor, the length of the delay and its potential impact on judicial proceedings, the reason for the delay, including whether it was within the reasonable control of the movant, and whether the movant acted in good faith.

Id. at 395 (footnote omitted). In applying the *Pioneer* test, courts are more likely to allow the late filing of a proof of claim where the notice of the bar date is inadequate or ambiguous or where the claimants are unsophisticated individuals. *See, e.g.*, Zilog, Inc. v. Corning (*In re* Zilog, Inc.), 450 F.3d 996, 1006–07 (9th Cir. 2006) (finding excusable neglect to permit the late-filing of certain proofs of claim because the subject claimants were unrepresented individuals and the bar date notice was ambiguous). Accordingly, depending upon the circumstances and the quality of notice provided, an unrepresented retiree that failed to file a proof of claim by a court-ordered bar date may be able to argue successfully that his or her failure to act was the result of "excusable neglect."

174 *See* 11 U.S.C. § 925.

175 *See, e.g.*, Birting Fisheries, Inc. v. Lane (*In re* Birting Fisheries, Inc.), 92 F.3d 939, 940 (9th Cir. 1996) (affirming the bankruptcy court's approval of the filing of a class proof of claim by a class of former employees asserting wage claims against the debtor); Reid v. White Motor Corp., 886 F.2d 1462, 1470 (6th Cir. 1989) (stating that bankruptcy courts are authorized to permit the filing of class proofs of claim and affirming the bankruptcy court's rejection of a class claim with respect to a class action seeking severance pay on behalf of the debtor's former employees because the class representative failed to comply with the procedural requirements for such claims); Am. Reserve Corp. v. Huddleston (*In re* Am. Reserve Corp.), 840 F.2d 487, 488, 493 (7th Cir. 1988) (holding that bankruptcy courts may exercise discretion to authorize the

If claim disputes arise, the bankruptcy court is empowered to hear those disputes. Although claimants may seek to have these issues moved to another forum for determination, the debtor has the ability to argue strongly to maintain these matters in the bankruptcy forum.[176] The bankruptcy court, moreover, has the ability to estimate these liabilities under § 502(c), which also applies in chapter 9.[177]

Where pension liabilities (or the calculation of these liabilities) are disputed, the bar date process may exert further pressure on affected claimants by forcing them to defend their position, and it brings claims disputes into the bankruptcy court (at least in the first instance). For example, in *Vallejo*, the City sought to unilaterally reduce retiree health benefits, arguing that its liability to affected retirees should terminate with the expiration of the collective bargaining agreements under which the benefits arose.[178] A committee of retirees countered that the claimants' rights to health benefits were vested under California law and, accordingly, fixed in perpetuity.[179] This

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filing of class proofs of claim and stating that "the right to file a proof of claim on behalf of a class seems secure").

176 In *S.G. Phillips Constructors, Inc.*, for example, the Second Circuit Court of Appeals held that a bankruptcy court had jurisdiction over a creditor's prepetition contract claim against the debtor. S.G. Phillips Constructors, Inc. v. City of Burlington, Vt. (*In re* S.G. Phillips Constructors, Inc.), 45 F.3d 702, 706 (2d Cir. 1995). Referring to the "basic principle that the filing of a proof of claim 'invokes the special rules of bankruptcy concerning objections to the claim, estimation of the claim for allowance purposes, and the rights of the claimant to vote on the proposed distribution'" the court reasoned that "'a claim filed against the estate is a core proceeding because it could arise only in the context of bankruptcy.'" *Id.* at 706 (quoting *In re* Manville Forest Prods. Corp., 896 F.2d 1384, 1390 (2d Cir. 1990).

177 Section 502(c) of the Bankruptcy Code provides that:

> There shall be estimated for purpose of allowance under this section—
>
> (1) any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case; or
>
> (2) any right to payment arising from a right to an equitable remedy for breach of performance.

11 U.S.C. § 502(c); *see also id.* § 901(a) (incorporating § 502 of the Bankruptcy Code into chapter 9 in its entirety).

178 *See* Transcript of Hearing at 12–13, *In re* City of Vallejo, 403 B.R. 72 (Bankr. E.D. Cal. 2009), *aff'd*, Int'l Bhd. of Elec. Workers, Local 2376 v. City of Vallejo (*In re* City of Vallejo), 432 B.R. 262 (E.D. Cal. 2010) (counsel to the City stating, "Our contention is that that period of time ends when those contracts [*i.e.*, the applicable collective bargaining agreements] would have expired under their own terms") (No. 710).

179 *See* Transcript of Hearing, *supra* note 178, at 20–22 (outlining the committee's position that the retirees' health benefits could not be reduced notwithstanding the expiration of the underlying collective bargaining agreement). Thus, in the committee's view, the proper calculation of the retirees' claims required an actuarial analysis to determine the amount of each claim. The issue of who should pay for these actuarial services was hotly contested. *See, e.g.*, *id.* at 37 (quoting counsel for the City, "I'm not really sure what the City is supposed to do when they hire an actuary. Calculate the claim according to how it doesn't think the claim should be calculated?").

dispute caused the bankruptcy court to impose a bar date on retirees and require submission of proofs of claim for lost health benefits.[180] In fact, because of the complexity of determining the amount of each retiree's entitlement to benefits, the committee and the debtor reached an agreement whereby, unless a retiree wished to propose his or her own means of calculating the applicable benefit, the retiree would simply choose between the committee's (more favorable) method and the debtor's (less favorable) method.[181] Nevertheless, each retiree was required to submit a proof of claim or else accept the debtor's calculation.[182] One likely result of the *Vallejo* bar date approach is that many retirees may have failed to file a proof of claim on or before the bar date and consequently lost their ability to challenge the debtor's calculation of their claims.[183] This potentially disparate treatment is a result the official retiree committee in *Vallejo* was striving to avoid.[184]

Notably, pensioners in *Vallejo* were not required to submit proofs of claim with respect to their pension benefits because, generally, the City paid all pension liabilities in full.[185] Nevertheless, the claims and bar date process could be adopted and applied to pension liabilities if a municipal debtor wished to contest these claims. Establishing a well defined claims process could exert further pressures on pension plan participants, create a mechanism and a forum to adjudicate claim disputes efficiently, and improve a debtor's negotiating position with respect to its pension liabilities.

[180] *See* Order Fixing Bar Date for Health Benefit Claims and Claims Based on Certain Pension Benefits, *In re City of Vallejo*, 403 B.R. at 72. (No. 781).

[181] *See* Proof of Claim Based on Impairment of Retiree Health Benefits and Payment of Reduced Pension Benefits, *In re City of Vallejo*, 403 B.R. at 72 (requesting by customized proof of claim form that retirees select a methodology for calculating their health benefit claims; the retirees were given the option of selecting (a) the formula advanced by the retiree committee, (b) the formula preferred by the City, or (c) some other formula that the retirees were asked to specify).

[182] The approved bar date notice for retiree health benefit claims provides that the claims of retirees who do not timely complete and file a proof of claim will be forever barred. *See* Order Fixing Bar Date, *supra* note 180, at 1–2.

[183] *But see* discussion on permissible late-filing of proofs of claim under the "excusable neglect" standard, *supra* note 173.

[184] *See* Transcript of Hearing, *supra* note 178, at 30 (counsel for the retiree committee alleging that the City was "sticking it to the retirees through a divide-and-conquer strategy and mov[ing] the committee to the side").

[185] *See* Order Fixing Bar Date, *supra* at 180, at 3 (stating that "[t]o date, the City has made all payments on account of pension benefits, and its intention is to continue to do so").

D. Plan of Adjustment

The ultimate goal of chapter 9 is to achieve confirmation of a "plan of adjustment"—the document that sets forth the specifics of how a municipality proposes to restructure its various obligations.[186] Section 943 of the Bankruptcy Code identifies the basic requirements for confirmation of a plan of adjustment.[187] In general, the confirmation requirements of § 943 incorporate those found in chapter 11 with respect to corporate plans of reorganization.[188] However, some changes in the confirmation standards are necessitated by the differences between private entities governed by chapter 11 and public municipalities governed by chapter 9.[189] Notably, unlike a chapter 11 debtor, a chapter 9 debtor cannot elect to liquidate substantially all of its assets.[190] Therefore, the "best interests of creditors" test for confirmation of chapter 11 plans[191]—which requires that non-accepting creditors fare at least as well under the plan as in a hypothetical chapter 7 liquidation—does not work the same way in chapter 9. Rather, as described below, the focus in chapter 9 is, more generally, whether the plan offers the best alternative available.

The plan of adjustment process may provide a municipality with one of its most significant tools to address its pension obligations. Unlike in chapter 11, the Bankruptcy Code prohibits any party other than the municipal debtor from proposing a plan of adjustment in a chapter 9 case.[192] Consequently, the municipal debtor fully controls the plan process and cannot be subjected to competing plans of adjustment propounded by third parties.

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186 *See* 11 U.S.C. § 109(c) (2006) ("An entity may be a debtor under chapter 9 of this title if and only if such entity . . . desires to effect a plan to adjust such debts . . . .").

187 *See id.* § 943(b) (requiring the bankruptcy court to confirm the plan if it meets seven requirements).

188 *See id.* § 943(b)(1) (requiring that the plan comply with those provisions of the Bankruptcy Code incorporated under section 901 of the Bankruptcy Code); *see also id.* § 901(a) (incorporating various chapter 11 plan and plan confirmation provisions including §§ 1122, 1123(a)(1), 1123(a)(2), 1123(a)(3), 1123(a)(4), 1123(a)(5), 1123(b), 1123(d), 1124, 1125, 1126(a), 1126(b), 1126(c), 1126(e), 1126(f), 1126(g), 1127(d), 1128, 1129(a)(2), 1129(a)(3), 1129(a)(6), 1129(a)(8), 1129(a)(10), 1129(b)(1), 1129(b)(2)(A), 1129(b)(2)(B), 1142(b), 1143, 1144, and 1145 of the Bankruptcy Code).

189 *Compare id.* § 943(b), *with id.* § 1129 (listing the confirmation requirements applicable to chapter 11 plans).

190 *See supra* note 34.

191 The best interests of creditors test is codified in § 1129(a)(7) of the Bankruptcy Code, which conditions confirmation of a plan on non-accepting creditors in impaired classes of claims "receiv[ing] or retain[ing] under the plan . . . a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date." 11 U.S.C. § 1129(a)(7).

192 *See id.* § 941 (providing that "the *debtor* shall file a plan" (emphasis added)).

Most fundamentally, a plan of adjustment may provide for impairment of certain types of claims. Although administrative priority claims (potentially including claims for pension benefits earned *after* the bankruptcy filing date) cannot be impaired, unsecured nonpriority claims may be subject to compromise if the confirmation requirements of § 943 of the Bankruptcy Code are met.[193]

There is limited case law on this topic in the chapter 9 context; however, several important lessons can be learned. For example, if the municipality has been authorized by the state to avail itself of chapter 9, state laws, ordinances, and other rules should not be available to impede the municipal debtor's efforts to use chapter 9 to impair and restructure its obligations.[194] Accordingly, even where state law establishes rules of priority or otherwise prefers one unsecured creditor over another, chapter 9 (and the state's voluntary agreement to permit chapter 9 filings) allows the debtor to disregard such state law preferences and impair the rights of such unsecured creditors.[195] In fact, even where a municipality otherwise would be unable to obtain relief from an obligation based upon constitutional restrictions upon the impairment of contracts by state legislation—the very basis for much of the argument that public pension obligations cannot be amended—case law seems to make clear that such restrictions do not hamper a chapter 9 municipality's attempts to impair these obligations.[196] These rules and others have resulted in a number of different types of impairment in chapter 9 plans of adjustment, including, among others,

[193] *See supra* note 189.

[194] *See* United States v. Bekins, 304 U.S. 27, 54 (1938) ("[T]he natural and reasonable remedy through composition of the debts of the district was not available under state law by reason of the restriction imposed by the Federal Constitution upon the impairment of contracts by state legislation. The bankruptcy power is competent to give relief to debtors in such a plight and, if there is any obstacle to its exercise in the case of the districts organized under state law it lies in the right of the State to oppose federal interference."); *In re* Corcoran Hosp. Dist., 233 B.R. 449, 460 (Bankr. E.D. Cal. 1999) ("'To create a federal statute based upon the theory that federal intervention was necessary to permit adjustment of a municipality's debts and then to prohibit the municipality from adjusting such debts is not, in the point of view of this Court, a logical or necessary result.'" (quoting *In re* City of Columbia Falls, Mont., Special Improvement Dist. No. 25, 143 B.R. 750, 760 (Bankr. D. Mont. 1992))); *see also* cases cited *supra* notes 143–44.

[195] *In re* Sanitary & Improvement Dist., # 7, 98 B.R. 970, 974 (Bankr. D. Neb. 1989). Although the court determined that the plan was not confirmable as filed, it also held that state law preferring bondholders to warrant holders would not necessarily prevent debtor from impairing bondholders while providing some value to warrant holders, in violation of state law, so long as "new bonds" issued pursuant to plan complied with applicable state law.

[196] *See Bekins*, 304 U.S. at 54; *In re City of Columbia Falls*, 143 B.R. at 759–60 (holding that chapter 9 preempts any state law that would otherwise impede a debtor's ability to impair its unsecured bond debt).

imposition of non-market rates of interest, extended repayment terms, and less than full payment of principal and interest.[197]

Ultimately, whether a particular municipality can successfully impair its pension obligations through a plan of adjustment depends on whether it can satisfy each of the confirmation requirements of § 943 of the Bankruptcy Code. This showing is extremely fact intensive and depends entirely upon the particular provisions of a municipal debtor's plan and the facts and circumstances leading to the municipal debtor's chapter 9 filing. Although a detailed review of each of the confirmation requirements of § 943 is beyond the scope of this article, several of the requirements deserve discussion.

Absent consent from all impaired classes of creditors, a municipal debtor must resort to the "cram down" provisions of § 1129(b) of the Bankruptcy Code, incorporated into chapter 9 by § 901.[198] The chapter 9 cram down rules permit a debtor to overcome a dissenting class of creditors (such as a class including pension holders) if the debtor can demonstrate that the plan does not "discriminate unfairly" against such dissenting class and that it is "fair and equitable" with respect to classes of secured and unsecured claims.[199] In chapter 9, this showing requires a court to examine whether the proposed treatment is all the impaired creditor "'can reasonably expect in the circumstances.'"[200] Although confirmation of any plan is a fact-intensive inquiry, given the extreme budgetary shortfalls and pension underfunding that currently exist, some municipalities presumably can make a strong argument that even significant impairment provides pension claimants with all they "can reasonably expect in the circumstances." As Prichard's mayor noted in

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197 *See, e.g.*, *In re* Westfall Twp., Case No. 09-02736 (Bankr. M.D. Penn, Mar. 2, 2010) (approving plan of adjustment that reduced $20 million judgment to $6 million and paid judgment through quarterly payments over the course of 20 years, without interest); *In re* Village of Alorton, Case No. 05-30055 (Bankr. S.D. Ill. Dec. 11, 2006) (approving plan of adjustment that paid judgment through monthly payments over the course of 20 years, with payments beginning after five years); *In re City of Columbia Falls*, 143 B.R. at 760 (stating that a chapter 9 plan of adjustment may provide for less than full payment of general obligation bonds, so long as other requirements of chapter 9 were met); *In re Sanitary & Improvement Dist., # 7*, 98 B.R. at 973–74 (explaining that general obligation bonds are general unsecured claims, subject to impairment); *In re* City of Camp Wood, Texas, Case No. 05-54480 (Bankr. W. D. Tex. June 13, 2007) (approving a plan of adjustment that impaired prepetition general obligation bond debt through (a) a principal reduction, funded by cash generated through a sale of assets; (b) a new 20-year amortization schedule; and (c) a new interest rate of 5%).

198 *See supra* note 188.

199 11 U.S.C. § 1129(b)(1) (2006). To confirm a plan of adjustment that impairs certain claims, at least one impaired class must have accepted the plan. *See id.* §§ 901, 943(b)(1), 1129(a)(10).

200 6 COLLIER, *supra* note 34, ¶ 943.03[1][f][i][B] (quoting Lorber v. Vista Irrigation Dist., 127 F.2d 628, 639 (9th Cir. 1941)).

response to unhappy retirees whose pension benefits were to be impaired in *Prichard II*, "You can't expect to get what we don't have."[201]

In addition, the court must examine whether the proposed plan is feasible, which requires a showing that there is a reasonable likelihood that the municipality's future tax revenues are sufficient to make the payments proposed by the plan.[202] The plan also must be the result of fair and equitable bargaining, openly arrived at and devoid of overreaching,[203] and must not discriminate unfairly against any particular class of creditors.[204] Each of these requirements makes clear that, not only must a municipal debtor negotiate with its pension holders, but the pension holders cannot disproportionately bear the impact of the municipality's proposed restructuring.

Other issues that must be addressed for the municipality to confirm its plan of adjustment include demonstrating that the plan is in the "best interests of creditors."[205] As noted above, in chapter 11, this test generally means that payments under the plan to creditors will yield at least as much as would be received on a liquidation of the debtor's business and the distribution of the proceeds to creditors.[206] This type of test does not work in chapter 9, however, because a municipality cannot be liquidated.[207] Thus, the best interests of creditors test in chapter 9 is interpreted to mean that the plan must be better than the alternative, which is dismissal of the case with every creditor left to fend for itself.[208]

Moreover, a municipal debtor must obtain all necessary regulatory approvals with respect to the plan provisions[209] and must demonstrate that the actions proposed by the plan are not prohibited by law.[210] Although these requirements should not impede a municipality's attempts to impair prepetition pension claims based upon prepetition pension plans, any unilateral attempt to

201 *Prichard Bankruptcy Brings Pensioners to Council Meeting*, WPMI Local 15, Mobile, Ala. (Oct. 29, 2009), *available at* http://www.local15tv.com/mostpopular/story/Prichard-Bankruptcy-Brings-Pensioners-to-Council/NMnXDMYgu0iIn9OvlFhjYQ.cspx.

202 *See* 6 COLLIER, *supra* note 34, ¶ 943.03[7][b].

203 Town of Belleair, Fla. v. Groves, 132 F. 2d 542 (5th Cir. 1942), *cert. denied*, 318 U.S. 769 (1943).

204 11 U.S.C. § 1129(b)(1).

205 *Id.* § 943(b)(7).

206 *See id.* § 1129(a)(7).

207 *See supra* note 34.

208 *See In re* Sanitary & Improvement Dist., # 7, 98 B.R. 970 at 975–76 (Bankr. D. Neb. 1989) (refusing to dismiss a chapter 9 case, which could result in a potentially chaotic scramble of individual creditors pursuing their rights in an *ad hoc* fashion).

209 11 U.S.C. § 943(b)(6).

210 *Id.* § 943(b)(4).

implement new or altered benefits on a going forward basis will likely be held to violate this requirement, absent appropriate legislative approval.[211]

Very few municipal debtors have attempted to use the chapter 9 plan of adjustment process to impair pension obligations. However, at least one confirmed plan of adjustment—the plan in *Prichard I*[212]—indicates that the use of a plan of adjustment to impair pension obligations may offer a viable alternative for municipalities. In *Prichard I*, the municipal debtor experienced significant and unsustainable shortfalls in its pension plan.[213] To address this and other issues, the debtor commenced a chapter 9 case and achieved confirmation of a plan of adjustment that included, as one of its most significant provisions, the impairment of claims relating to pension obligations.[214] In particular, the *Prichard I* plan of adjustment included, among others, the following terms: (1) a $16.5 million cash infusion to be paid to the pension plan in 2009, approximately nine years after the confirmation of the plan of adjustment; (2) reduction of all existing and future pension benefit payments by 8.5%; (3) no future pension increases for retirees based upon wage increases for employees; (4) potential further reductions in benefits based upon future plan performance; and (5) an agreement to seek legislative approval of certain other changes to the plan.[215] It is unclear how the debtor in *Prichard I* was able to obtain court approval of the sweeping relief set forth in the plan of adjustment, some of which goes beyond the mere impairment of unsecured nonpriority obligations and actually effects a modification of an existing pension plan. Whatever the court's basis, the *Prichard I* plan of adjustment provides support for the notion that impairment of pension benefits through a plan of adjustment is possible.

Nine years later, the City of Prichard filed its second chapter 9 case, *Prichard II*, and proposed a plan of adjustment that included significant impairment of pension obligations, including the termination of its pension

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211 *See, e.g.*, *In re* City of Columbia Falls, Mont., Special Improvement Dist. No. 25, 143 B.R. 750, 760 (Bankr. D. Mont. 1992) (holding that § 943(b) does not prevent attempts to impair the rights of prepetition bondholders but, instead, "applies to postpetition actions after confirmation of the plan; a city may not, for example, issue bonds as part of a plan that will not conform to all state law requirements for such bonds").

212 *See* Order Approving Disclosure Statement and Confirming Plan of Readjustment of Debts at 6–7, *In re* City of Prichard, Alabama, Case No. 99-13465 (Bankr. S.D. Ala. Oct. 6, 2000) (No. 123).

213 *See* Corkery, *supra* note 138 (reporting that Prichard filed its 1999 chapter 9 petition when it "simply ran [out] of money to pay its pension obligations").

214 *See* Order Approving Disclosure Statement and Confirming Plan of Readjustment of Debts, *supra* note 212, at 6–7.

215 *See id.*

plan for current employees and the establishment of a new pension plan.[216] Not surprisingly, Prichard's retirees did not welcome, or consent to, this plan of adjustment and ultimately obtained a dismissal of the entire case as described above.[217] Unless the City's appeal is successful in reinstating the chapter 9 case, the bankruptcy court will never rule on Prichard's second plan of adjustment. Still, the City's efforts to use the bankruptcy process to restructure its pension obligations could yet serve as a model for other municipalities looking for a solution to their overwhelming pension liabilities.[218]

CONCLUSION

Underfunded pension obligations constitute one of the most significant problems facing municipalities across the country. Restructuring pension benefits is a challenge because they often enjoy significant protection under state law. Although it remains unclear whether municipalities will elect to pursue the protections and benefits of chapter 9 of the Bankruptcy Code in large numbers, chapter 9 offers tools to municipalities wishing to pursue a fundamental restructuring of pension obligations. Will these tools succeed in permitting municipalities to achieve the pension restructurings that they desperately need? That is not clear. Because the treatment of pension obligations is complex, chapter 9 does not offer simple, off-the-shelf solutions and there are few if any relevant precedents for how treatment of such obligations would play out in chapter 9. Nevertheless, in jurisdictions where it is available, chapter 9 of the Bankruptcy Code at a minimum may provide a municipal debtor with helpful tools to significantly improve its negotiating position with respect to its pension obligations. For example, the City of Vallejo chose to avoid any direct confrontation with its pension holders in its chapter 9 case, yet still achieved reductions in its liabilities indirectly by rejecting and renegotiating certain collective bargaining agreements. By

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[216] First Amended Plan of Adjustment, *In re* City of Prichard, Ala. (*Prichard II*), No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009) (Docket No. 131).

[217] *See* Laura Stuart, *Prichard Pensioner: Bankruptcy Plan is 'Ridiculous,'* LOCAL 15 NEWS (May 20, 2010), *available at* http://www.local15tv.com/news/local/story/Prichard-Pensioner-Bankruptcy-Plan-is-Ridiculous/tyxUbvn6ZEC7n22SMsoWKQ.cspx (quoting a pensioner as stating that "[n]ot only. . .is [the proposed plan] ridiculous to the retirees, it is ridiculous for the city fathers to even come up with such an asinine plan to pay their retirees. Those people who have given their lives for the city"); *supra* Part III.A (discussing dismissal of the City's chapter 9 case).

[218] *See* Corkery, *supra* note 138 (stating that although "bankruptcy law remains murky on how far a city or town can go in scrapping deals for current retirees, cases like *Prichard* and other workout efforts stand to reshape the debate over how local governments deal with mounting public-pension problems").

contrast, the City of Prichard had no such compunction, and *Prichard II* may provide inspiration to troubled municipalities as they weigh their alternatives.

At the end of the day, wherever they have a choice, municipalities very well may decide that practical and political considerations outweigh the potential for cutting pension liabilities in chapter 9. Where there are alternatives, municipalities may be loath to face the negative media attention, labor upheaval, and political fallout of cutting pension entitlements for active employees or retirees. Chapter 9, however, is intended to be a forum of last resort for municipalities that have run out of options. For such municipalities that are crippled by overwhelming pension obligations, the tools of chapter 9 may offer some needed relief.