Stockton, California, Ruling: Bankruptcy Court Powerless to Prevent Retiree Benefit Reductions by Municipal Debtor

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Amid the economic hardships brought upon us by the Great Recession, the plight of cities, towns, and other municipalities across the U.S. has received a significant amount of media exposure. The media has been particularly interested in the spate of recent chapter 9 bankruptcy filings by Vallejo, Stockton, San Bernardino, and Mammoth Lakes, California; Jefferson County, Alabama; Harrisburg, Pennsylvania; and Central Falls, Rhode Island. A variety of factors have combined to create a virtual maelstrom of woes for U.S. municipalities—a reduction in the tax base caused by increased unemployment; plummeting real estate values and a high rate of mortgage foreclosures; questionable investments; underfunded pension plans and retiree benefits; decreased federal aid; and escalating costs (including the higher cost of borrowing due to the meltdown of the bond mortgage industry and the demise of the market for auction-rate securities). Addressing any one of these issues is a challenge for a municipality. Together, the burden has been too great for some municipalities to bear.

One option available to certain municipalities facing potential financial catastrophe is to seek relief under chapter 9 of the Bankruptcy Code. Chapter 9 for a long time was an obscure and little used legal framework, but it has grown more prominent in recent years as an option for struggling municipalities. Chapter 9 allows an eligible municipality to "adjust" its debts by means of a "plan of adjustment," similar in many respects to a plan of reorganization in a

chapter 11 bankruptcy case. However, due to constitutional concerns rooted in the Tenth Amendment's preservation of each state's individual sovereignty over its internal affairs, the resemblance between chapter 9 and chapter 11 is limited.

This inherent constitutional tension was the subject of a ruling recently handed down by a California bankruptcy court. In *In re City of Stockton, California*, 478 B.R. 8 (Bankr. E.D. Cal. 2012), the court held that: (i) the debtor city could unilaterally reduce the benefits of its retirees without offending the Contracts Clause of the U.S. Constitution (even where those benefits otherwise may be considered contractual in nature under state law); and (ii) the court was not permitted to enjoin the debtor from implementing the benefit reductions due to the express limitations on a bankruptcy court's jurisdictional mandate in chapter 9 cases. The court also affirmed the jurisdiction of bankruptcy courts to make such determinations and declined a request to cede jurisdiction of this dispute to state courts in California.

Municipal Bankruptcy Law

Ushered in during the Great Depression to fill a vacuum that previously existed in both federal and state law, federal municipal bankruptcy law has been plagued by a potential constitutional flaw that endures in certain respects to this day—the Tenth Amendment reserves to the states sovereignty over their internal affairs. This reservation of rights caused the U.S. Supreme Court to strike down the first federal municipal bankruptcy law as unconstitutional in *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513 (1936), and it accounts for the limited scope of chapter 9, as well as the severely restricted role the bankruptcy court plays in presiding over a chapter 9 case and in overseeing the affairs of a municipal debtor.

The Supreme Court later validated a revised municipal bankruptcy statute in *United States v. Bekins*, 304 U.S. 27 (1938), concluding that revisions to the law designed to reduce the opportunity for excessive federal control over state sovereignty struck a constitutionally permissible balance. The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City's financial crisis and bailout by the New York State government in 1975, but chapter 9 has proved to be of limited utility. Historically, relatively few cities or counties have filed for chapter 9 protection. The vast majority of chapter 9 filings have involved municipal instrumentalities, such as irrigation districts, public-utility districts, waste-removal districts, and health-care or hospital districts. In fact, according to the Administrative Office of the U.S. Courts, fewer than 650 municipal bankruptcy petitions have been filed in the 75 years since Congress established a federal mechanism for the resolution of municipal debts in 1937. Fewer than 280 chapter 9 cases have been filed since the current version of the Bankruptcy Code was enacted in 1978—although the volume of chapter 9 cases has increased somewhat in recent years. By contrast, there were 1,529 chapter 11 cases filed in 2011 alone.

Constitutional Compromises

Access to chapter 9 is limited to municipalities under section 109(c)(1) of the Bankruptcy Code. A "municipality" is defined by section 101(40) of the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State." Section 109(c) of the Bankruptcy Code identifies other mandatory prerequisites to relief under chapter 9, including the requirement that the municipality be "specifically authorized, in its capacity as a municipality or by name, to be a debtor under [chapter 9] by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under [chapter 9]."

More than half of the states have no statute specifically authorizing municipalities to file for chapter 9 relief, meaning that a municipality in these states cannot file for bankruptcy unless a statute is enacted specifically authorizing a filing. Elsewhere, the nature of state authorizing statutes varies greatly. Some states generally authorize *any* municipality to file for chapter 9 relief, while many other states restrict municipal bankruptcy filings to certain limited circumstances or require certain prior approvals and consents. In either case, once the conditions to a filing have been achieved and the filing occurs, the entirety of chapter 9 applies. Even so, chapter 9 establishes a framework of debt adjustment that is constrained by the U.S. Constitution. Various provisions of chapter 9 establish strict limitations to preserve the delicate constitutional balance between state sovereignty and federal bankruptcy power. Several key examples are described below.

First, section 903 of the Bankruptcy Code expressly reserves to the states the power "to control, by legislation or otherwise," municipalities that file for chapter 9 protection, with the caveat—and the significant limitation—that any state law (or judgment entered thereunder) prescribing a method of composition of indebtedness among a municipality's creditors is not binding on dissenters.

Second, section 904 of the Bankruptcy Code provides that unless the debtor consents or the plan so provides, the court may not "interfere" with any of the debtor's "political or governmental powers," any of the debtor's property or revenues, or the use or enjoyment of its income-producing property. Thus, unlike a chapter 11 debtor, a municipal debtor is not restricted in its

ability to use, sell, or lease its property (e.g., section 363 does not apply in a chapter 9 case), and the court may not become involved in the debtor's day-to-day operations. Also, unlike in a case under chapter 7, 11, 12, or 13 of the Bankruptcy Code, a municipal debtor's assets do not become part of the debtor's bankruptcy estate upon the filing of a chapter 9 petition.

In addition, control of a municipal debtor is not subject to defeasance in the form of a bankruptcy trustee (although state laws commonly provide a mechanism for transferring control of the affairs of a distressed municipality). A trustee, however, may be appointed to pursue avoidance actions (other than preferential transfers to or for the benefit of bondholders) on behalf of the estate if the debtor refuses to do so. A municipal debtor is not subject to the reporting requirements and other general duties of a chapter 11 debtor.

A chapter 9 debtor enjoys many of the rights of a chapter 11 debtor in possession but is subject to few of the obligations. Pursuant to section 901, many (but not all) of the provisions contained elsewhere in the Bankruptcy Code are expressly made applicable to chapter 9 cases. These include, among others, the provisions with respect to the automatic stay; adequate protection; secured post-petition financing; executory contracts; administrative expenses; a bankruptcy trustee's "strong arm" and avoidance powers; financial contracts; the formation of official committees; and most, but not all, of the provisions governing vote solicitation, disclosure, and confirmation of a chapter 11 plan. Among other sections, the incorporated provisions omit the following: (i) section 1113, which establishes the circumstances and procedures under which a debtor can reject a collective bargaining agreement; (ii) section 1114, which governs the

payment of retiree benefits during bankruptcy; or (iii) section 541, which provides that an estate consisting of all of the debtor's property is created upon the filing of a bankruptcy petition.

Limitations on a bankruptcy court's power to control a municipal debtor's affairs were addressed by the court in *Stockton*, and these limitations were fundamental to its decision.

Stockton Bankruptcy Filing

Stockton is the 13th-largest city in the State of California, with a population of nearly 300,000. On June 28, 2012, it became the largest city to file for chapter 9 protection in U.S. history. Burdened by a $26 million budget shortfall, the city council adopted a budget for the fiscal year commencing July 1, 2012, which by state law was required to be balanced. To achieve a balanced budget, the city council imposed significant cost cutting, including a unilateral reduction in retiree health benefits.

A group of Stockton's retirees responded by filing a class-action adversary proceeding in the chapter 9 case seeking, among other things, injunctive relief preventing Stockton from unilaterally cutting benefits or, in the alternative, modification of the automatic stay to seek such relief in state court. The retirees contended that they had vested contractual rights protected from impairment by the Contracts Clause of the U.S. Constitution, a similar clause in the California Constitution, and other provisions of state law. The complaint, however, made no reference to section 904 of the Bankruptcy Code, an omission that the court later directed must be remedied by means of briefing by the retirees on the issue and a statement by Stockton as to whether it consented to the court's resolution of the health benefit payment dispute. Stockton did not consent.

The Bankruptcy Court's Ruling

Supremacy of the Bankruptcy Clause

The bankruptcy court denied the request for injunctive relief and dismissed the adversary proceeding. At the outset, the court examined the Contracts Clause of the U.S. Constitution (Art. I, § 10, cl. 1), which provides that "[n]o State shall . . . pass any . . . Law impairing the Obligations of Contracts." The court emphasized that this constitutional provision bans a *state* from making a law impairing a contractual obligation, but "it does not ban [the U.S.] *Congress* from making a law impairing the obligation of a contract." In short, the court explained, "the shield of the Contracts clause crumbles in the bankruptcy arena." According to the court, Congress is expressly vested by the Bankruptcy Clause of the U.S. Constitution (Art. I, § 8, cl. 4) with the power to establish uniform bankruptcy laws, and it, unlike the states, is not prohibited from passing laws impairing contracts:

> The goal of the Bankruptcy Code is adjusting the debtor-creditor relationship. Every discharge impairs contracts. While bankruptcy law endeavors to provide a system of orderly, predictable rules for treatment of parties whose contracts are impaired, that does not change the starring role of contract impairment in bankruptcy.

By operation of the Supremacy Clause of the U.S. Constitution (Art. VI, cl. 2), the court determined that the same analysis applies to the contracts clause in California's state constitution. Moreover, by authorizing a municipality to file for relief under chapter 9, a state invites the intervention of federal bankruptcy law to impair contractual relationships.

State Sovereignty Prevails in Chapter 9

The court prefaced its discussion regarding the retirees' request for injunctive relief with the observation that "[a] delicate state-federal relationship of mutual sovereigns in which the Tenth Amendment looms large provides the framework for municipal bankruptcy and gives context to

this dispute." Sections 903 and 904, the court explained, honor the state-federal balance "by reserving certain state powers and by correlatively limiting the powers of the federal government."

The court focused primarily on section 904, including a careful examination of its provenance reaching back to 1934, which entailed several iterations of the present-day provision. That history, the court explained, reflects lawmakers' "sedulous" efforts "to avoid unnecessary intrusions of state sovereignty in order to obviate the risk of invalidation by the Supreme Court." Addressing the relief sought by Stockton's retirees, the court wrote that "[t]he message derived from this history . . . compels the conclusion that § 904 prevents any federal court from doing what the plaintiffs request, regardless of whether the City's action is fair or unfair."

Overall, the court emphasized, section 904 "performs the role of the clean-up hitter in baseball." The court wrote that the language of the provision

> is so comprehensive that it can only mean that a federal court can use no tool in its toolkit—no inherent authority power, no implied equitable power, no Bankruptcy Code § 105 power, no writ, no stay, no order—to interfere with a municipality regarding political or government powers, property or revenues, or use or enjoyment of income-producing property.

As a practical matter, the court concluded, "the § 904 restriction functions as an anti-injunction statute—and more."

The court rejected the retirees' arguments that section 904 does not apply because: (i) their challenge was limited to the role of Stockton as employer, rather than government regulator; and (ii) injunctive relief "would be an innocuous preservation of the status quo that would not

directly interfere with City property or revenues," given the retirees' fixed and immutable rights to health benefits. According to the court, section 904(2) is dispositive on these points. "Coercively preserving a status quo that entails payment of money from the City treasury," the court wrote, "interferes with the City's choice to suspend such payments." The court accordingly ruled that the relief sought by the retirees is barred by section 904(2) as an interference with Stockton's "property or revenues."

The court rejected the retirees' argument that some equivalent of section 1114 be implemented to prevent Stockton from unilaterally reducing retiree benefits, even though section 1114 is not among the provisions of the Bankruptcy Code made applicable in chapter 9 cases by section 901(a). Whether the omission was by design or oversight is irrelevant, the court explained. "The delicate constitutional balance that has loomed large over municipal bankruptcy ever since *Ashton*," the court wrote, "further cautions against taking liberties to cure perceived legislative mistakes." According to the court, the retirees' remedy for Stockton's actions lies in participating in the claims-resolution process (i.e., filing a proof of claim for breach-of-contract damages), as well as the city's process of formulating a chapter 9 plan of adjustment.

Finally, the bankruptcy court denied the retirees' request for an order modifying the automatic stay to permit them to seek redress in a forum that purportedly does have the power to grant them relief (i.e., California state court). It reasoned that resolution of the dispute between Stockton and the retiree-creditors is "central to the debtor-creditor relationship to be dealt with, along with every unhappy creditor, in the collective chapter 9 proceeding."

Outlook

Stockton is an important ruling, although it remains to be seen whether the decision will be upheld on appeal. In addition to illustrating the limitations on a bankruptcy court's jurisdiction in municipal bankruptcy cases, the decision potentially opens the door in other chapter 9 cases to the impairment of vested contractual rights under retiree benefit plans without complying with the protections for retirees applicable in chapter 11 cases under section 1114 of the Bankruptcy Code. It is an additional blow to the rights of municipal employees and retirees in the wake of the ruling in *In re City of Vallejo, California*, 432 B.R. 262 (E.D. Cal. 2010). In *Vallejo*, the district court affirmed a bankruptcy-court ruling that section 1113 of the Bankruptcy Code does not apply in chapter 9, potentially making it easier for a municipal debtor to reject a collective bargaining agreement.

It is also possible that the court's reasoning could be extended to permit the impairment of other kinds of municipal obligations, including municipal bond debt, beyond the impairment already permitted in connection with the confirmation of a chapter 9 plan of adjustment. However, given the increased future borrowing costs to a defaulting municipality resulting from the impairment of the claims of municipal bondholders, the threat of impairment may be of only limited utility as a bargaining chip to obtain concessions.