NATIONAL ASSOCIATION OF PUBLIC PENSION ATTORNEYS

JUNE 2015 LEGAL EDUCATION CONFERENCE

MUNICIPAL BANKRUPTCY WORKING GROUP PANEL DISCUSSION

June 26, 2015 8:00–9:30 am

Panelists:

- Honorable Thomas B. Bennett - Chief Judge, Unites States Bankruptcy Court for the Northern District of Alabama
- Robert D. Gordon - Member, Clark Hill PLC
- Peter Mixon - Partner, K&L Gates, LLP
- Harvey L. Leiderman - Partner, Reed Smith LLP

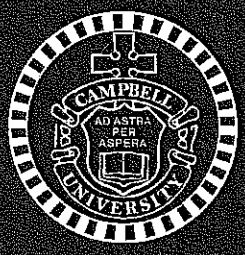
Outline of Topics:

- Reflections upon the Jefferson County bankruptcy
- Reflections upon the Detroit bankruptcy
- Reflections upon the Stockton bankruptcy
- State legislative or other "gateway" controls as hurdles to municipal bankruptcy
- State sovereignty in Chapter 9: pension plans as an exercise of core governmental powers
- Pension funds' fiduciary duties in an employer bankruptcy
- Classification and treatment of bondholder and pension claims and related issues relative to confirmation of a plan of adjustment.
- Treatment of unfunded actuarial accrued liability as "debt" and calculation of the claim amount.

Attached Resources:

- Hon. Thomas B. Bennett, Consent: Its Scope, Blips, Blemishes and a Bekins Extrapolation Too Far, 37 Campbell L. Rev 3 (2015).
- Presentation by Harvey L. Leiderman, "My Contract Is Better Than Your Contract…Right?" Will Public Pensions Survive Bankruptcy Court?"

CAMPBELL LAW REVIEW



CONSENT: ITS SCOPE, BLIPS, BLEMISHES, AND A *BEKIAS* EXTRAPOLATION TOO FAR

Hon. Thomas B. Bennett

Volume 37 Symposium 2015 Number 1

Keynote Address

Consent: Its Scope, Blips, Blemishes, and a *Bekins* Extrapolation Too Far*

HON. THOMAS B. BENNETT**

Today, consent is a topic of much debate in the bankruptcy realm, as is evidenced by the Supreme Court's recent and upcoming considerations of the ability of private parties to consent to a bankruptcy judge's adjudication of matters that without consent, may necessitate determination by a federal judge having lifetime tenure. Though some of what is to be presented has application to this context, it is not the subject for consideration here. Rather, it is the scope, blips, and blemishes that swirl around one sovereign's consent to jurisdiction over a part of it, a subdivision of a state, by another sovereign, the United States. More precisely, it is whether the perceived scope of consent to a federal court's bankruptcy jurisdiction over a state's municipal subdivision is correct. A number of reported decisions of bankruptcy courts, and even more legal articles, espouse the idea that once a state authorizes—that is, consents—to the filing of a Chapter 9 bankruptcy case by one of its municipalities, neither the state, the municipality, nor anyone else may reject the use of any parts of Chapter 9 along the road to readjustment of debts.

To view the scope of consent, a structural framework must be recalled. It is the relationship of the states to the United States under the Constitution, which is often referred to as federalism, and involves the interplay of how dual sovereigns have allocated, reserved, and, yes, ceded, powers. Remember that neither the Constitution nor the Bill of Rights came first. Rather, it was the Articles of Confederation, which vested very little power in what we view now as the Executive Branch of our government. Instead, Congress held the most power under a structure that retained in the hands of the thirteen colonies many of the critical powers necessary for an effective central government.

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* This is a lightly footnoted adaptation of the Keynote Address that was delivered on October 17, 2014, for the *Campbell Law Review*'s Symposium, "One City at a Time: The Role and Increasing Presence of Municipal Bankruptcies."

** Chief Bankruptcy Judge, United States Bankruptcy Court for the Northern District of Alabama.

Experiencing the failings of such a structure initiated the process that led to enactment of the Constitution, along with the Bill of Rights. Among other things, the Constitution is a ceding of powers held by the state sovereigns to a central government. Some are absolutely given up, and others are given up only upon the federal government's exercise of powers granted to it by the various states through the Constitution. One that is given up only on the United States' exercise of its constitutional grant is that for the provision of uniform laws on bankruptcy.

What was a serious afterthought to the Constitution is the Bill of Rights, and for our purposes, the Tenth Amendment's reservation to the states or to the people, the "powers not delegated to the United States by the Constitution, nor prohibited by it to the states.[1] It is the evolving, dynamic interplay of what is reserved to the states under the Tenth Amendment with that which is ceded or allocated to the central government, along with what is denied to the states under the Constitution that is the structure that must be dissected to have some idea of what may be the boundary of consent of a state to one of its parts being subjected to the federal government's exercise of its Bankruptcy Clause powers.

The structure is the Constitution, but to understand how broad or limited the impact of a state's consent to the filing of a municipal bankruptcy is, the details of the framing need consideration. These details include: (1) the Supreme Court's rationale for striking down the 1934 municipal bankruptcy law,[2] along with its reasoning for upholding the 1937 Act;[3] (2) the structure of the first, second, and current municipal bankruptcy laws—the 1934 enactment,[4] the 1937 statute,[5] and today's Chapter 9 of the Bankruptcy Code;[6] (3) the Tenth Amendment;[7] (4) the Contract Clause[8] and its prohibition on state impairment of contracts; (5) the Bankruptcy Clause, the Taxation Clause, and the Commerce Clause, all of which are contained in Article 1, Section Eight, of the Constitution;[9] and

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1. U.S. CONST. amend. X.

2. *See* Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513 (1936) (invalidating the 1934 Act).

3. *See* United States v. Bekins, 304 U.S. 27 (1938) (upholding the 1937 Act).

4. Municipal Bankruptcy Act of 1934, ch. 345, 48 Stat. 798, *invalidated by Ashton*, 298 U.S. 513.

5. 11 U.S.C. §§ 401–404, *amended by* Act of Apr. 8, 1976, Pub. L. No. 94-260, 90 Stat. 315 (current version codified in scattered sections of 11 U.S.C.).

6. 11 U.S.C. §§ 901–946 (2012).

7. U.S. CONST. amend. X.

8. *Id.* art. I, § 10, cl. 1.

9. *Id.* art. I, § 8, cls. 1 (Taxation Clause), 3 (Commerce Clause), 4 (Bankruptcy Clause).

(6) the shifting dichotomy regarding the ability of the United States to exercise the powers accorded to it, and the limits on its exercise of those powers on states as revealed—some may say muddled—by Supreme Court decisions.

What will not be considered other than briefly is the issue of immunity, including sovereign immunity and the Eleventh Amendment. This is because the view regarding consent considered here has developed through case law that did not rely on immunity in its various forms or on the Eleventh Amendment. This case authority was premised solely on the interaction of the Tenth Amendment with the Bankruptcy Clause powers accorded to the United States.

Although not the focus of the analysis presented, there will be a discussion of immunity, including sovereign immunity, and to the extent used in cases to be mentioned on this topic, the Eleventh Amendment. However, this portion of the presentation deals with what are further complexities in determining the environs of consent of a state to imposition of federal power on it or a subdivision.

These are the framing materials with which one must work. It is by consideration of these that one learns of the blips and blemishes of and to consent. As the review and analysis progresses, all that I request is that any preconceived views on what is the perimeter of consent be set to one side.

I. CONSENT: THE *ASHTON* VIEW AND ITS *BEKINS* REVISITATION

A. Ashton v. Cameron County Water Improvement District No. 1[10]

Perhaps the easiest entry into this consent discussion is to outline the abrupt shift in the position of the Supreme Court from that used to reject the first municipal bankruptcy law. This shift occurred within a span of just under two years, from May 1936 to April 1938.

The rejection of consent as a basis on which the federal government could exercise its Bankruptcy Clause powers to enable subdivisions of a state to file a case under the Bankruptcy Act of 1898 occurred in *Ashton v. Cameron County Water Improvement District No. 1*.[11] The statute under consideration was the 1934 amendment to the Bankruptcy Act, which added the first municipal bankruptcy law. The Supreme Court recognized that the law only allowed voluntary municipal bankruptcies. The Court described the contents of portions of the three sections comprising the 1934 Act, including quoting one provision that prevented impairment of or

10. Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513 (1936).

11. *Id.*

limitation on a state's powers to control a municipality in the exercise of its political or governmental powers, and another part that restrained the bankruptcy court's exercise of its powers and jurisdiction over the political and governmental powers of the municipality, including the use and enjoyment of its revenues, properties, and expenditures. Nonetheless, the Court determined that it "need not consider this act in detail or undertake definitely to classify it."[12] In other words, the analysis was *not* done with reference to specific provisions of the 1934 Act.

Rather, the Court in *Ashton* focused on the dual sovereignty of our federal structure. It analogized the Supreme Court's taxation case law holdings that the federal government could not tax certain aspects of a state's exercise of its retained sovereign powers as being the same sort of prohibited conduct as the imposition of the federal bankruptcy powers on municipalities. This determination overlooked and did not mention its contrary case law on taxation that was cited in Justice Cardozo's dissent,[13] in which consent by one sovereign to taxation of activities of another had been upheld.

Additionally, the *Ashton* Court looked at the 1934 Act as allowing the states to do what they could not do directly: impair contracts. It read the 1934 Act as allowing the states to indirectly impair contracts and, as a result, the Court viewed the Act as allowing an impermissible activity by a state under the Contract Clause. With respect to consent to the exercise of the Bankruptcy Clause powers, the Court said that "[n]either consent nor submission by the states can enlarge the powers of Congress."[14] Thus, a state's authorization for the filing of a bankruptcy case by a municipality did not solve what the Supreme Court then viewed as the inability of the federal government to expand its grant of powers under the Constitution over the retained sovereign rights of states by the simple expedient of consent. Nor could consent be the basis under the Bankruptcy Clause to enable states to do indirectly what the Constitution prohibited states to do: impair contracts. One other point is that the Tenth Amendment determination made in *Ashton* was done without analytical consideration of whether the specifics of what was in the 1934 Act transgressed the demarcations set by the Tenth Amendment.

12. *Id.* at 527.

13. *Id.* at 538–39 (Cardozo, J., dissenting).

14. *Id.* at 531 (citing United States v. Butler, 297 U.S. 1 (1936)).

B. United States v. Bekins[15]

Quickly after the *Ashton* ruling, the second municipal bankruptcy law was enacted,[16] and it was just as swiftly attacked as unconstitutional. By April of 1938, the Supreme Court in *United States v. Bekins* determined that the 1937 Act was an appropriate exercise of Congress's Bankruptcy Clause powers.[17] The Court looked at the contents of the four sections that made up this law, in conjunction with its revised view on consent by a state.

In *Bekins*, unlike in the *Ashton* decision, the Supreme Court gave detailed attention to the contents of the statute. One point was that only a voluntary bankruptcy petition could be filed. Another was that this law involved compositions that the Court had determined in earlier decisions to be within the Bankruptcy Clause powers of Congress. A third was rejection of the *Ashton* concept, that use of the Bankruptcy Clause powers enabled states to indirectly impair contracts in contravention of the Contract Clause. The *Bekins* Court reiterated that the Contract Clause did not bar the United States from impairing contracts, which is what had occurred under the 1937 Act. Thus, no state impairment of contracts was involved.

Most importantly, the Supreme Court revised its view on consent in *Bekins*. The Court reviewed its prior precedent regarding consent between two sovereigns and concluded that consent by one sovereign to the otherwise impermissible taking of an action by another, such as taxing or contracting, was not in derogation of sovereignty. Rather, it was "the essence of sovereignty to be able to . . . give consents bearing upon the exertion of governmental power."[18] The Court also determined that the Tenth Amendment protected and did not destroy the right of states to give consent where the action consented to would not contravene the provisions of the Constitution. The *Bekins* ruling was purely anchored in the Tenth Amendment without consideration of the case-law-based doctrines of immunity, including intergovernmental immunity, or the Eleventh Amendment.

In conjunction with this revised view on consent, the Court also considered specific aspects of the structure of the 1937 Act. These considerations included the necessity of state authorization for such a filing, the requirement that state law authorize all actions that are necessary to carry out the composition, the degree of prebankruptcy agreement by

15. United States v. Bekins, 304 U.S. 27 (1938).

16. Act of Aug. 16, 1937, ch. 657, 50 Stat. 653.

17. *Bekins*, 304 U.S. at 37.

18. *Id.* at 51–52.

affected creditors that was mandated, along with the confirmation requisite of two-thirds of the aggregate amount of affected claims for approval of the plan, and two subsections that limited application of the Bankruptcy Clause powers to a state's exercise of its political and governmental powers and the powers and jurisdiction of a bankruptcy court over the municipal debtor. These two subsections are the forerunners of what is in §§ 903 and 904 of the current Bankruptcy Code.[19]

Based on these factors, the *Bekins* Court determined that the 1937 Act was carefully crafted to not impinge on state sovereignty, that the state retains control over its political, governmental, and fiscal affairs, and the filing of the case and approval of the plan are authorized by state law, approved by the bankruptcy court, and agreed upon by the municipality.[20]

From this context, *it viewed consent as one where the essence of statehood, its sovereignty, is maintained without impairment.*[21] Put differently, and in the economic climate of the late 1930s, it enabled the states to achieve the readjustment of debts of insolvent municipalities that the states could not do on their own due, in part, to the predominant view since *Sturges v. Crowninshield*[22] that the Contract Clause prohibits impairment of contracts by states.[23] It is an instance whereby granting consent to the intervention of the federal government's exercise of the Bankruptcy Clause powers over state subdivisions, "[t]he State acts in aid, not in derogation, of its sovereign powers. It invites the intervention of the bankruptcy power to save its agency which the State is powerless to rescue."[24]

Important in the upholding of the 1937 Act in *Bekins* was this revisited view on state consent. It was one that expressly looked at the structure of how the 1937 Act was crafted to ensure that its structure did not impair what the Court perceived as the essence of sovereignty. More simply put, and unlike in the *Ashton* decision, what was in the 1937 Act was critical to the determination that the consent given by the states did not impair their essential sovereign powers.

Despite *Ashton* and *Bekins* being alike in the sense that both rulings were founded purely on the Tenth Amendment, there was a difference in the Court's analytical approach. In *Bekins*, the Supreme Court reviewed the contents of the 1937 Act to ascertain that its grasp did not extend into

19. 11 U.S.C. §§ 903, 904 (2012).
20. *Id.* at 37.
21. *Id.* (emphasis added).
22. Sturges v. Crowninshield, 17 U.S. 122 (1819).
23. *Id.* at 207.
24. *Bekins*, 304 U.S. at 54.

the powers of states protected by the Tenth Amendment. The analysis was done in two steps. First was the determination of whether the Tenth Amendment barred consent by a state to what would otherwise have been an impermissible application of the Bankruptcy Clause powers on a state's municipal subdivisions.[25] Second, the Court had to confirm that the provisions of the 1937 Act did not exceed the limits imposed by the Tenth Amendment.[26]

Bekins clearly stands for the constitutional ability of a state to consent to the United States' exercise of its Bankruptcy Clause powers by expanding its bankruptcy laws to embrace a state's municipal subdivisions, so long as the manner of the embrace does not impair the essential aspects of state sovereignty. This is a far different and more greatly limited holding than is embodied in the views of many today, that consent to the filing of a municipal bankruptcy is tantamount to a state's or others' inability to successfully object to application of any of the provisions that are now in Chapter 9 of the Bankruptcy Code. To fully understand this view requires knowing what was in the 1934 and 1937 Acts compared to today's Chapter 9 Bankruptcy Code.

II. THE COMPARISONS: CHAPTER IX OF THE 1934 ACT, CHAPTER X OF THE 1937 ACT, AND CHAPTER 9 OF THE BANKRUPTCY CODE

Next in the consideration of the scope of consent is outlining the contents of the failed 1934 Act, and then the 1937 Act, which survived constitutional scrutiny. The 1934 Act[27] was three sections long, and only one of the sections, section 80,[28] contained subsections. One of the sections, section 78,[29] dealt with the policy underlying the enactment of a municipal bankruptcy law. A second, section 79,[30] contained the jurisdictional grant for municipal bankruptcies. The last, section 80,[31] constituted the provisions detailing the how, where, and when that a municipality may file for bankruptcy, have a plan of readjustment of debts confirmed, and exit from bankruptcy. Moreover, section 80 delineates the necessity of having the plan of adjustment filed with the bankruptcy petition, along with a statement that, depending on the type of municipal

25. *Id.* at 52.

26. *Id.* at 53.

27. Municipal Bankruptcy Act of 1934, ch. 345, 48 Stat. 798, *invalidated by* Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513 (1936).

28. *Id.* § 80, 48 Stat. at 798–803.

29. *Id.* § 79, 48 Stat. at 798.

30. *Id.* § 78, 48 Stat. at 798.

31. *Id.* § 80(a), 48 Stat. at 798–99.

entity, no less than either 30% or 51% in the aggregate amount of claims of certain creditors affected by the plan had approved it.[32] Essentially, it is a filing requirement that one have a degree of pre-filing approval of the plan of adjustment.[33] For confirmation, the requisite amount of affected claims by class of creditor and the requisite amount of all claims of all classes of creditors approving the plan was required and varied by municipal entity from 66 ⅔% to 75%.[34]

In addition to this confirmation requirement, others that are the same or similar to the current provisions of § 943 of the Bankruptcy Code needed to be met. However, there is one significant difference between the contents of Chapter IX of the 1934 Act and the current Chapter 9.

Chapter IX was almost wholly self-contained. By this, I mean that with two exceptions, no other provisions of the Bankruptcy Act were incorporated as part of the 1934 Act. The two exceptions were § 93(h)[35] for determining the extent of a creditor's secured status, and § 29[36] regarding certain stays of actions. Other than these two exceptions, the requirements for entry into, through, and exiting from Chapter IX were governed solely by the eleven subsections of section 80.[37] The precursor to § 903 of the Bankruptcy Code, section 80(k)[38] of the 1934 Act, limited the ability of the municipal bankruptcy laws to "limit or impair the power of any State to control, by legislation or otherwise, any political subdivision thereof in the exercise of its political or governmental powers, including expenditures therefor."[39]

Similarly, the earliest version of the restrictions on the jurisdiction and powers of a bankruptcy court was set forth in section 80(c)(11).[40] This subsection limited the powers of a bankruptcy judge by specifying that the judge "shall not, by any order or decree, in the proceeding or otherwise, interfere with (a) any of the political or governmental powers of the taxing district, or (b) any of the property or revenues of the taxing district *necessary in the opinion of the judge* for essential governmental purposes, or (c) any income-producing property, unless the plan of readjustment so provides."[41]

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32. *Id.* § 80(b), 48 Stat. at 799.
33. *Id.* § 80(c), 48 Stat. at 800.
34. *Id.* § 80(d), 48 Stat. at 801.
35. 11 U.S.C. §§ 506(a), (b) (2012).
36. *Id.* § 108.
37. Municipal Bankruptcy Act of 1934 §§ 80(a)–(*l*), 48 Stat. at 798–803.
38. *Id.* § 80(k), 48 Stat. at 802.
39. *Id.*
40. *Id.* § 80(c)(11), 48 Stat. at 801.
41. *Id.* (emphasis added).

Although very similar—some may say identical, in large parts—the 1937 Act[42] had slight, but subtle differences. The second municipal bankruptcy law was composed of four sections. Only one of these four sections, section 83,[43] contained subparts. Two of the sections, sections 81[44] and 84,[45] dealt with jurisdiction. Section 81 was the grant of jurisdiction, and section 84 set its termination. Section 82[46] set forth four definitions for Chapter X, which was later redenominated as Chapter IX. In nine subsections, section 83[47] set forth the how, when, and where the municipal-bankruptcy process begins and the how to get through and out of Chapter IX. Its process for entry through exiting was very similar to that of the 1934 Act.

One difference from both the 1934 Act and today's Chapter 9 is that the 1937 Act was completely self-contained. There were no references to or inclusions from other sections of the Bankruptcy Act contained within the 1937 Act. In fact, the language is explicit regarding a host of matters from the requirements for the filing of the petition, to challenging the filing, to the components of the plan of composition, to confirmation, and to exiting from Chapter IX: all are evaluated on compliance with the provisions of "this chapter," not other parts of the Bankruptcy Act outside of Chapter IX.

Although the filing requirement of having the approval in writing of the requisite number in dollar amount of creditors affected by the plan of composition remained part of the municipal bankruptcy law, it is altered from the 1934 Act by merging what had been two categories of municipal debtors into one, and by having only one applicable prebankruptcy written approval standard: not less than 51% in dollar amount of the aggregate of all claims of creditors affected by the plan regardless of the type of claim. The confirmation requirement was also altered so that it had one acceptance standard for confirmation: by at least two-thirds of the aggregate amount of all classes of allowed claims affected by the plan the overwhelming majority of which was required to have been obtained before the filing of the municipal bankruptcy case.[48] This version of Chapter IX was designed to be essentially a prepackaged plan.

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42. Act of Aug. 16, 1937, ch. 657, 50 Stat. 653.
43. *Id.* § 83, 50 Stat. at 655.
44. *Id.* § 81, 50 Stat. at 654.
45. *Id.* § 84, 50 Stat. at 659.
46. *Id.* § 82, 50 Stat. at 654.
47. *Id.* § 83, 50 Stat. at 655–59.
48. *Id.* § 83(a), 50 Stat. at 655.

The two most noteworthy alterations in the 1937 Act are those made to what had been in the subsections dealing with the restrictions on the ability of Chapter 9 to limit or impair a state's political or governmental powers to control the municipal debtor, and those restrictions on the powers of a bankruptcy court by any order or decree founded on bankruptcy or nonbankruptcy law to interfere with the municipal debtor's political or governmental powers, its property or revenues, or its income-producing properties. The modification to the provision designed to retain the legislatively perceived proper amount of state control over the municipal debtor was to clarify the protection of state powers from the 1934 Act's section 80(k) "any political subdivision thereof"[49] to being "any municipality or any political subdivision of or in such State"[50] in section 83(i) of the 1937 Act.

The far more important alteration was the expansion of the limits on a bankruptcy court's powers by the wording of section 83(c), which deleted only six words from the 1934 Act: "in the opinion of the judge," regarding the inability of the bankruptcy court, absent the consent of the municipality in its plan, to interfere with its property or revenues "necessary for essential governmental purposes."[51] More simply, this deletion eliminated any discretion that a bankruptcy judge may have had under the statute to determine if a municipality's use of properties or revenues was truly necessary for essential governmental purposes. The elimination of these six words, along with the 1976 deletion of the phrase "necessary for essential governmental purposes," have been carried forward into what is now in § 904 of the Bankruptcy Code.[52]

The absence of provisions from both the 1934 and 1937 Acts, which are parts of Chapter 9 of the Bankruptcy Code, is another component in the consideration of the scope of consent by a state to its subdivisions' filing of a bankruptcy case. From 1937 until 1976, little of Chapter IX changed with respect to its self-contained structure. However, and as is often the case, the specter of large—in size and complexity—municipal bankruptcies caused a change. The impetus for Congress to revisit how Chapter IX worked arose from the fear of an impending filing of bankruptcy by large cities and the belief that the existing simple, four-section, self-contained structure was unworkable for such large and complex potential filings. Beginning with amendments in 1976 to Chapter IX of the Bankruptcy

49. Municipal Bankruptcy Act of 1934 § 80(k), 48 Stat. at 802.

50. Act of Aug. 16, 1937, § 83(i), 50 Stat. at 659.

51. *Id.* § 83(c), 50 Stat. at 659.

52. 11 U.S.C. § 904 (2012).

Act,[53] the self-contained structure came to an end. Various aspects of powers available in corporate and individual bankruptcy cases were added to those powers that were utilizable by municipal debtors. This process of incorporating aspects of other bankruptcy chapters into the municipal bankruptcy chapter continued into and after the enactment of the Bankruptcy Code.

Today, twenty sections are contained within Chapter 9, many of which have multiple subsections. Added to these sections is incorporation into Chapter 9 of the Bankruptcy Code of parts of or all of fifty-four sections via § 901(a).[54] Another twelve sections are added to Chapter 9 by § 103(f), which states that "[e]xcept as provided in § 901 of this title, only chapters 1 and 9 of this title apply in a case under such Chapter 9."[55]

The subject matter of these eighty-six sections or parts of sections is varied and ranges from what is innocuous to those which are of significance when it comes to analyzing the view of the impact and scope of consent that many bankruptcy courts perceive it to be. Included in this range of provisions are appointment of a healthcare ombudsman, immunity from criminal prosecution for persons required to provide information in a bankruptcy case, unclaimed-property distribution, the impact of dismissal of a case, assumption or rejection of executory contracts, reopening of a case, disposition of patient records, adequate protection of an interest in property, the automatic stay, obtaining secured credit, termination and retention of utility services, sections regarding creditors and their claims, others regulating debtor duties and benefits, yet more on the subject of obtaining and retaining property of a municipal debtor, and various and sundry sections dealing with the administration and reorganization of a debtor that are located in Chapter 11.

A couple of examples point out the extrapolation too far of the *Bekins* ruling on consent. One section that is external to, but incorporated into Chapter 9 that is a blip is § 301(b) of the Bankruptcy Code, which specifies that the commencement of a voluntary case constitutes an order for relief under the chapter in which it is filed.[56] However, § 921(d) specifies that if a Chapter 9 petition is not dismissed for failure of the municipality to comply with the prerequisites to filing or is not dismissed based on a bad-faith filing, the court "shall order relief under this chapter notwithstanding § 301(b)."[57] Was the inclusion of § 301(b) warranted or necessary? No.

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53. *See* Act of Apr. 8, 1976, Pub. L. No. 94-260, 90 Stat. 315.
54. 11 U.S.C. § 901(a).
55. *Id.* § 103.
56. *Id.* § 301(b).
57. *Id.* § 921(d).

Moreover, it has no impact on a state's sovereignty beyond what the *Bekins* court determined to be permissible.

At the other end of the spectrum of importance are certain sections brought into Chapter 9 by § 901(a).[58] One is the waiver of sovereign immunity in § 106.[59] It applies to a litany of sections within Chapter 9 and those brought into Chapter 9 via §§ 103(f) and 901(a). The § 901(a) importing includes a waiver of sovereign immunity for thirty sections or parts thereof listed in § 106(a) that are brought into Chapter 9 via either §§ 103(f) or 901(a). At this time, no case law has considered how § 106(a)'s "[n]otwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit to the extent set forth in this Section,"[60] that is, its waiver of sovereign immunity, interacts with either § 903's limit or restriction on impairment of the power of states to control their municipalities or § 904's limits on the jurisdiction and powers of a bankruptcy court. More importantly, no reported opinion addresses the Tenth Amendment's constraints on it in the context of a bankrupt municipality. This is a large blemish. Particularly disquieting for the current view of consent fostered by some is that other than the *Bekins* view of consent from a Tenth Amendment prism, no issue regarding waiver of sovereign immunity was—indeed by Chapter IX's self-contained nature could not have been—considered as part of the Supreme Court's upholding of the 1937 Act.

Equally troublesome is that the incorporation of the waiver of sovereign immunity by § 901(a) is reciprocated by § 106(a)'s listing of § 901 as a section of the Bankruptcy Code for which its waiver of immunity applies. This creates a conundrum and reveals a further blemish in the position espoused by those who assert that once a state consents to its municipality filing a Chapter 9, all of that which is in Chapter 9 has been consented to apply.

Consider that § 901(a) lists fifty-four sections or parts of sections outside of Chapter 9 that are brought by it into Chapter 9.[61] Thirty-two of these sections are not mentioned in § 106(a)'s listing of sections of the Bankruptcy Code to which its waiver of sovereign immunity applies. Yet § 106(a) specifies that the waiver of sovereign immunity applies to § 901(a), which is a subsection that only lists other parts of the Bankruptcy Code brought into Chapter 9.[62] The difficulty is that the structure of these

58. *Id.* § 901(a).
59. *Id.* § 106(a).
60. *Id.*
61. *Id.* § 901(a).
62. *Id.* § 106(a).

two sections and how they may be interpreted allows one to argue that the waiver of § 106(a) has been expanded by how § 901 is dealt with by § 106(a). This is not a blip. It, too, is a blemish in the currently articulated belief that consent to a municipal bankruptcy filing by a state is consent to application of all that is within Chapter 9 to either the state or its municipal subdivision.

In a similar vein, another example is § 926's allowance of the appointment of a trustee to exercise certain avoidance powers should a municipal debtor elect not to pursue them.[63] Yet §§ 903 and 904 purport to preclude certain interferences with how a state or a municipality uses its expenditures, revenues, and properties. Even if one can rationalize the workings of § 926 with those of §§ 903 and 904, § 926's use of a trustee to obtain back expenditures, revenues, or properties from or of a state or municipality is of questionable value when one understands that under § 904, a municipality need simply return the expenditure, revenue, or property to the entity from which they were recovered! Furthermore, one must pay attention to the fact that §§ 903 and 904, as did their lineal predecessors, reflect Congress's view on what are the aspects of state sovereignty that may not, absent consent, be imposed under the Bankruptcy Clause. This is not necessarily the same view as that contained within the Constitution and the Tenth Amendment.

Far more serious, though, is § 106(a)'s express waiver of sovereign immunity of a state, municipality, and other governmental units for purposes of § 926's appointment of a trustee to exercise the avoidance powers that the municipal debtor determines not to exercise. The interplay of §§ 903 and 904, and more significantly, the Tenth Amendment, are simply ignored by the statute as drafted. Does this waiver trump either or both of the provisions of § 903 or § 904? Even if it does, it cannot overcome the Tenth Amendment, should the waiver or § 926 transgress the boundary set by it. Again, a blemish exists in the position taken by some that the consent to file under Chapter 9 means that a state or its municipality has consented to all that is within Chapter 9.

These are but a few examples of sections within Chapter 9 and brought into Chapter 9 via §§ 103(f) and 901(a) that were never part of either the 1934 or 1937 Acts, and that impact in various ways a state's sovereignty beyond those that were reviewed by the Supreme Court in *Bekins*. Others exist. The impact of the fact that none of these were, nor could they have been, considered by the Supreme Court in *Bekins* has never been addressed in any reported decision that indicates that a state's consent

63. *Id.* § 926.

to bankruptcy jurisdiction for its subdivisions equates to consent by either the state or its subdivision to application of all that is today's Chapter 9.

The scope of consent considered by the Supreme Court when it struck down the 1934 Act and upheld the 1937 Act was done in the context of statutes that did not have a part of the municipal bankruptcy law's numerous sections currently encapsulated into Chapter 9. The consent discussions by the Court in both *Ashton* and *Bekins* were done in the context of far less of a statutory reach than what exists in Chapter 9 of the Bankruptcy Code. This is one more major distinction that is not considered by the current view of consent to bankruptcy jurisdiction equating to the waiver of challenges to using all parts of the Bankruptcy Code in or brought into Chapter 9.

III. THE *MISSION INDEPENDENT SCHOOL DISTRICT* PROGENY

Further demonstrating that this aspect of the analytical framework of *Bekins* has been overlooked is revealed by deciphering the cases upon which rests the theorem that consent to bankruptcy by a state for its municipality is consent to all that is within the current version of Chapter 9. The source of this view of consent is sometimes disclosed as a 1940 decision of the United States Court of Appeals for the Fifth Circuit, *Mission Independent School District v. Texas*.[64] What followed in 1989 was *In re Sanitary & Improvement District, No. 7*,[65] some forty-nine years and a significantly different law later. Then in 1992 came *In re City of Columbia Falls, Special Improvement District No. 25*,[66] followed by *In re County of Orange* in two opinions, one in 1995[67] and the other in 1996,[68] *In re City of Vallejo*[69] (2009), *In re Jefferson County*[70] (2012), *In re City of Stockton*[71] (2012), and *In re City of Detroit*[72] (2013). Each of the courts in *Vallejo*, *Stockton*, *Detroit*, and yes, that judge in *Jefferson County*, effectively adopted what had been pronounced by the courts from *In re Sanitary & Improvement District No. 7* and thereafter: that authorization to

64. Mission Indep. Sch. Dist. v. Texas, 116 F.2d 175 (5th Cir. 1940).

65. *In re* Sanitary & Improvement Dist., No. 7, 98 B.R. 970 (Bankr. D. Neb. 1989).

66. *In re* City of Columbia Falls, Special Improvement Dist. No. 25, 143 B.R. 750 (Bankr. D. Mont. 1992).

67. *In re* Cnty. of Orange, 183 B.R. 594 (Bankr. C.D. Cal. 1995).

68. *In re* Cnty. of Orange, 191 B.R. 1005 (Bankr. C.D. Cal. 1996).

69. *In re* City of Vallejo, 403 B.R. 72 (Bankr. E.D. Cal. 2009), *aff'd*, 432 B.R. 262 (E.D. Cal. 2010).

70. *In re* Jefferson Cnty., 474 B.R. 228 (Bankr. N.D. Ala. 2012).

71. *In re* City of Stockton, 475 B.R. 720 (Bankr. E.D. Cal. 2012).

72. *In re* City of Detroit, 504 B.R. 97 (Bankr. E.D. Mich. 2013).

file a municipal bankruptcy is consent to all of what is in today's Chapter 9.[73]

Scrutiny of *Mission Independent School District* reveals several factors not considered in these courts' rulings espousing their views on the scope of consent. One is that *Mission* was decided in the context of the same four self-contained sections that *Bekins* considered. Another is that *Mission* dealt with the issue of whether a Texas statute authorizing the filing of a municipal bankruptcy could also set the priority of payment of certain creditors ahead of others in disregard of what the Bankruptcy Act set as the priorities in Chapter IX. Third, the provisions for confirmation in section 83(e) of the Bankruptcy Act set the confirmation requirements to include "fair, equitable, and for the best interests of the creditors and does not discriminate unfairly in favor of any creditor or class of creditors."[74] Fourth, section 83(b) of the 1937 Act mandated "[t]hat the holders of all claims, regardless of the manner in which they are evidenced, which are payable without preference out of funds derived from the same source or sources *shall be one class*."[75] Lastly, most of the discussion in *Mission* entailed the invalidity of the Texas authorizing statute under Texas's state constitution, which raises the specter that the bankruptcy law discussion may be viewed as dicta.

For this discussion, the most important aspect is that *Mission* was decided within the ambit of the limited provision then in Chapter IX, not the myriad of those that have been incorporated into today's law via §§ 901(a) and 103(f). All that was addressed involved the classification and confirmation criteria of the version of Chapter IX that the *Bekins* Court had reviewed, not the numerous and sundry provisions that are in today's law that were not before the *Mission* Court.

Added to these is the basis on how the current view of consent was arrived at and articulated in *Sanitary & Improvement District*, *City of Columbia Falls*, *County of Orange*, *City of Vallejo*, *City of Stockton*, and *City of Detroit*, in reliance on *Mission*. In their analysis of the contested provisions, these courts did not mention, let alone use, the *Bekins* standard for consent in the Tenth Amendment context, which is that the statutory provision(s) under review may not impair a state's sovereign powers. Rather, each of these cases use wording with identical import. It is that states which have authorized a municipal entity to file Chapter 9 which have, as part of the authorization or other law, language that, in practical

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73. *In re* Sanitary & Improvement Dist., No. 7, 98 B.R. 970, 975–76 (Bankr. D. Neb. 1989).

74. Act of Aug. 16, 1937, ch. 657, § 83(e), 50 Stat. 653, 658.

75. *Id.* § 83(b), 50 Stat. at 657 (emphasis added).

effect, prevents a municipal debtor from adjusting debt is contrary to Congress's intent for adopting the laws regulating municipal bankruptcies. As the court stated more simply in *County of Orange*, a state "must accept [C]hapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest."[76] All of this is another reason for why the current position held by many on consent that purportedly flows from *Bekins* is too far of an extrapolation. This is especially poignant when one knows that it occurred in cases that did not entail full consideration of the factors involved in making such an extrapolation.

IV. THREE FURTHER COMPLEXITIES: CASE LAW, IMPAIRMENT, AND SOVEREIGNTY

Although already complex, there are three areas of law that need mentioning, each of which, standing alone, presents ambiguities. When added to the municipal bankruptcy scope of consent envisioned by the *Bekins* Court, these ambiguities highlight perplexing and troublesome issues that are left unresolved under existing Supreme Court precedent.

One issue is how to determine the type of state activity or function that is shielded by the Tenth Amendment from the exercise of powers granted to the United States by the states under the Constitution. Prior to *New York v. United States*,[77] a simple rule was used to differentiate between state activities or functions upon which the United States could exercise its various constitutional grants of powers and those with respect to which it could not. They could not be exercised with respect to governmental activities, but could be imposed on the proprietary or business activities of a state. This standard was abandoned in *New York* as being unworkable in the evolving world that saw states undertaking as their functions activities that previously had only been done by the private sector. What was tried next was use of a standard looking to the usual traditional and essential governmental functions to differentiate those state actions on which the United States could impose its constitutionally founded powers on state functions and activities.

This criterion proved equally unavailing when it came to differentiating which state functions and actions were subject to the application of federal law. Next was *National League of Cities v. Usery*,[78] which was a basis for an amendment to the Bankruptcy Act and which used

76. *In re* Cnty. of Orange, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996).

77. New York v. United States, 505 U.S. 144 (1992).

78. Nat'l League of Cities v. Usery, 426 U.S. 833 (1976), *overruled by* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528 (1985).

the differentiating standard of areas of traditional governmental function such as fire and police protection, sanitation and public health, and parks and recreation. This measuring criterion was thrown out in *Garcia v. San Antonio Metropolitan Transit Authority*.[79]

Somewhat of a quandary is that the *Garcia* Court rejected the adoption of a specific rule of state immunity from federal regulation that turns on a judicial appraisal of whether a particular function or activity of a state is integral or traditional because it prevents a court from accommodating changes in the historical functions of states which have resulted in a number of formerly private functions, such as education, being assumed by the states or their subdivisions. The *Garcia* Court's refusal to adopt a specific standard for when federal power may be imposed on state functions and activities leaves us with no definitive, articulated factors upon which one may flesh out whether any of the sections of Chapter 9 in the *Bekins* consent formulation impair a state's sovereignty beyond what *Bekins* determined was acceptable.

New York v. United States involved the Taxation Clause, and *National League of Cities* and *Garcia* revolved around the Commerce Clause. *Bekins* involved the Bankruptcy Clause. Each of these cases involved clauses in Article I, Section Eight, of the United States Constitution.[80] Each of these cases also involved considerations of sovereignty and the imposition of federal power on actions by a state. For these reasons, *New York*, *National League of Cities*, and *Garcia* may assist, to a limited degree, in fleshing out whether and what provisions of Chapter 9 under the *Bekins* consent view either impair or do not impair the sovereign powers of a state.

At the same time, *New York*, *National League of Cities*, and *Garcia* create a problem. Embedded in the Court's analysis in these three cases is the case-law-developed concept of intergovernmental immunity, which, as will be mentioned, *involves* sovereignty, but is different from sovereignty. These are major complexities that remain unresolved.

Added to this complexity is the Supreme Court's holding in *Central Virginia Community College v. Katz*.[81] In *Central Virginia Community College*, the Supreme Court dealt with not just the waiver of sovereign immunity in the context of a proceeding to recover a preferential transfer from a college that was viewed as a subpart of the State of Virginia.[82] Despite the extensive discussion of immunity—particularly sovereign immunity—the Court did not rest its decision on a waiver of sovereign

79. *Garcia*, 469 U.S. at 528.

80. U.S. CONST. art. I, § 8.

81. Cent. Va. Cmty. Coll. v. Katz, 546 U.S. 356 (2006).

82. *Id.* at 360.

immunity. Rather, the Court focused on whether Congress could subject states to certain bankruptcy proceedings under the Bankruptcy Clause granted power to enact "Laws on the subject of Bankruptcies," which involved a private person or entity as the debtor.[83] It was based on the Bankruptcy Clause powers superseding sovereign immunity.

Thus, it was not a decision on the full scope of sovereignty, which needs to be distinguished from sovereign immunity and that of the Tenth Amendment. Likewise, it was not a case dealing with the scope of consent of a state to its subdivision filing a Chapter 9 case. That is, a case where the debtor is a subdivision of the state. Just how broad the Bankruptcy Clause powers of Congress are regarding the implications of a state's consent to the filing of a Chapter 9 as perceived by the *Bekins* court is not resolved by *Central Virginia Community College*. In its most basic sense, *Central Virginia Community College* is the Bankruptcy Clause's overpowering of sovereign immunity, not sovereignty and its Tenth Amendment shield.

The second complication involves revisiting just what is impairment of a contract by a state under the Contract Clause. There are at least three categories for what is such an impairment.

I classify the first as the "absolutist view." It is the predominant view under case law, particularly that involving bankruptcies. Under this view, any change in the amount to be paid back or altering of the other rights under a contract, regardless of the time value of what is to be received, is an impairment.

The second is one that I call the "economic view." It is that leaving all other factors unaltered, such as items like the collateral security, what is the appropriate consideration is the present value of what is to be received under the contract terms versus the present value of what is to be received under the modified terms. If the value to be received under the modified terms equals or exceeds that under the contract terms, there is no impairment. If it does not, then there is impairment. The economic view is part of the justification for why an extension of a contract is not a composition and, as a result, does not result in the impairment of a contract. However, some courts have begun to recognize that the extension case law has only looked at part of the economic equation by focusing only on continued payments at altered interest rates for a short term. As pointed out in *Ropico, Inc. v. City of New York*,[84] a long-enough delay in repayment and/or a sufficient decrease in the interest rate will eventually become enough of an alteration to impair a contract in the constitutional sense.

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83. *Id.* at 359.

84. Ropico, Inc. v. City of N.Y., 425 F. Supp. 970 (S.D.N.Y. 1976).

The third conceptualization of impairment is the view espoused by Justice Frankfurter in *Faitoute Iron & Steel Co. v. City of Asbury Park*.[85] This view may be referred to as the "realist view." Essentially, this view considers receipt of less than the face value of the payment provided for under a contract as not constituting an impermissible impairment under the Contract Clause, so long as what is received is equal to or greater than the market value of the obligation at the time of the restructuring of the indebtedness. Because of comments by the Supreme Court in *United States Trust Co. of New York v. New Jersey*,[86] some view *Faitoute* as an outlier that has no persuasive value. However, it should not be so casually disregarded.

Both the *Ropico* and *Faitoute* opinions have independently incorporated into the legal analysis something that, over time, the Supreme Court has done with its views on the exercise of federal power over state functions and activities: the process of what is a sovereign activity of a state is not static and should not be viewed as such. Similarly, the evolution of the bankruptcy law has not been and should not be static. What has become more important over time is not artificial and rigid designations for terms like "impairment." What is critical is the reality of the situation. Under either the economic view or Justice Frankfurter's realist view, the analysis is whether what you receive is equal to or better than what one would receive under the terms of an unaltered obligation. Should either conceptualization of impairment become the accepted view on impairment, the entire realm of municipal debt adjustment will be altered. In fact, it may obviate the need for a municipal bankruptcy in some cases.

The last of the three complexities is recognition that sovereignty is not identical to sovereign immunity. It is accurate that sovereign immunity involves sovereignty considerations. However, it does not define the set of factors that constitute sovereignty. At best, sovereign immunity is a set of factors that may be seen as either partially intersecting the set of sovereignty or as a subset of sovereignty. It does not fully occupy the global set that is sovereignty. Thus, the case law that looks at immunity of states from the imposition of federal laws on their activities should not be seen as necessarily considering factors identical to those of the Supreme Court in *Bekins* concerning sovereignty in its Tenth Amendment context. Some will be the same, but not all. This becomes more significant when one knows that certain subdivisions of states, such as counties, cities, and others are generally, not necessarily always, viewed under case law as

85. Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942).

86. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1 (1977).

lacking the sovereign characteristics with which the states of the United States are endowed. This is the rest of why the Supreme Court's and lower federal courts' opinions present obstacles to evaluating the sovereignty factors of importance in *Bekins*: they often do not distinguish between sovereignty and immunity, including sovereign immunity, as part of their analysis of the ability of the federal government to impose its laws on state functions and activities.

CONCLUSION

The espousal of some that a state's authorization of its subdivisions to file a municipal bankruptcy case equates to it and others not being able to avoid application of all sections of the Bankruptcy Code that are part of Chapter 9 is an overstatement of what *Bekins* viewed as consent by a state in aid of its sovereign powers. No court opinions that recite what I call the "no cherry pick" rule involved much, let alone a full, consideration of the structure and framing of the structure of the Constitution regarding the perimeters of the ability of a state to consent to imposition of federal bankruptcy powers over its municipal subdivisions. Nor do they discuss the fact that the current municipal bankruptcy law's provisions are far broader in reach and impact on a state's exercise of its sovereign powers than those in the 1937 Act, or recognize that its limited provisions contained in only four sections were directly relevant to and were an integral part of the *Bekins* ruling. This current view of consent by many is, at a minimum, generalized dicta accorded far too great a significance. It is most likely incorrect regarding some of what are the fringes of the provisions of Chapter 9 of the Bankruptcy Code, which were never, and could not have been, part of the Supreme Court's *Bekins* analysis.

A more correct and limited view of the *Bekins* holding regarding consent by a state to its subdivisions filing a municipal bankruptcy case is that it supports such a filing under Chapter 9 of the Bankruptcy Code and it remains to be seen how much of what has been added to the municipal bankruptcy law may be objected to by a state, its municipality in bankruptcy, and others such as creditors and parties in interest. The conclusion is that the absolute nature of the so-called "no cherry pick" rule is unsupported by a critical analysis of the constitutional structure regarding sovereignty, the *Bekins* holding, and the context in which *Bekins* was decided. Accordingly, this view on consent should be relegated to the realm of nothingness! Paraphrasing Justice Frankfurter, "the dictum . . . is one of those inaccurate generalizations that ha[s] gained momentum from

uncritical repetition."[87] What remains to be done by the courts is the fleshing out of the boundaries of consent of a state set by the Constitution, including its applicable amendments, done in the context of the analytical steps used by the *Bekins* Court, conjoined with consideration of the bundle of facts unique to each case.

87. *Faitoute*, 316 U.S. at 513.

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The business of relationships.℠

"MY CONTRACT IS BETTER THAN YOUR CONTRACT…RIGHT?"
WILL PUBLIC PENSIONS SURVIVE BANKRUPTCY COURT?

MATERIALS FOR THE
NATIONAL ASSOCIATION OF PUBLIC PENSION ATTORNEYS
LEGAL EDUCATION CONFERENCE * AUSTIN, TEXAS
June 26, 2015

Harvey L. Leiderman
Reed Smith LLP

BANKRUPTCY – LAY OF THE LAND

- Federal Constitutional framework
  - Supremacy clause
  - Uniform bankruptcy laws
- Purpose
  - Debtor prisons abolished
  - Breathing spell
  - Encourage compromise
  - Alter obligations
  - Fresh start
  - Avoid relapse

PRIVATE/PUBLIC DIFFERENCES

- **Private – Chapters 7, 11 & 13**
  - Individuals and corporations
  - Liquidation
  - Reorganization
- **Public – Chapter 9**
  - Municipalities
  - Adjustment of debts

PRIVATE/PUBLIC DIFFERENCES

- **Eligibility**
  - **Private – Any individual, partnership, corporation**
  - **Public – States are gatekeepers for municipalities**
- **Control of the Estate**
  - **Private – Debtor or court-appointed trustee**
  - **Public – Municipal officials**

PRIVATE/PUBLIC DIFFERENCES

- Court supervision
  - Private – all post-petition operations
  - Public – no court interference
- Plan proposals
  - Private – any interested party
  - Public – only the municipal debtor

WHY IS CHAPTER 9 DIFFERENT?

- **Federalism and the Tenth Amendment – Powers Reserved to the States**
  - **Bankruptcy abrogates state sovereign immunity, but…**
  - **Bk. Code 903 – No interference with State control of Muni's political and governmental powers**
  - **Bk Code 904 – No interference with Muni's control over administration, property use or spending during Chapter 9**

TYPES OF DEBTOR OBLIGATIONS

- **Statutory**
  - Taxes, easements
  - Liens
  - Pensions?
- **Contractual**
  - Secured (real estate loans, revenue bonds)
  - Unsecured (trade, general obligation bonds, installment agreements, under-secured portion of secured claims)
  - Leases (real estate, equipment)
  - Collective bargaining agreements

THE BIG DEAL ABOUT CONTRACTS

- It's where "debt" and "obligations" come from
- No successful plan of reorganization or adjustment ("fresh start") without impairing contractual obligations
- It's what bankruptcy judges probe for; far less latitude to alter statutory obligations

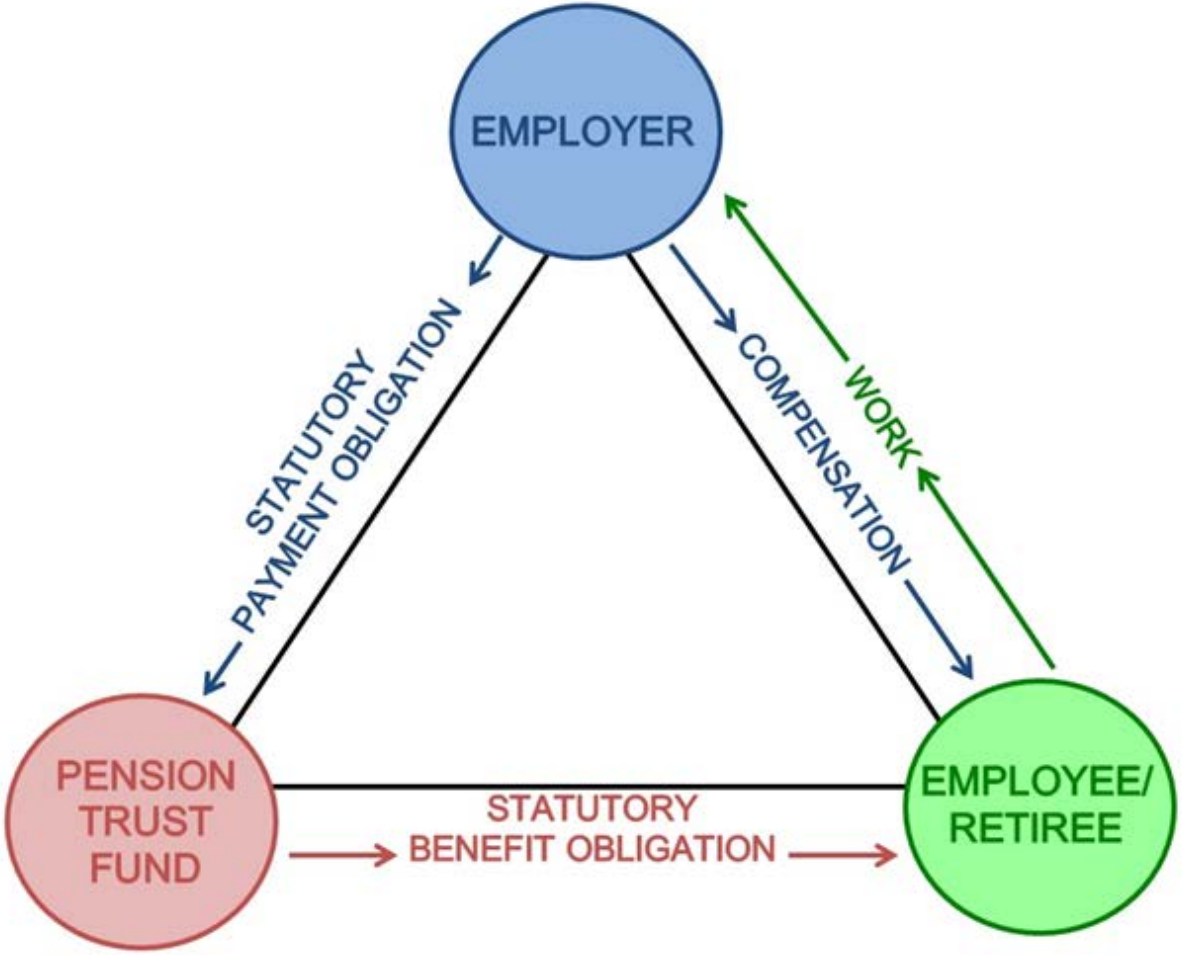
BANKRUPTCY POWER TO IMPAIR CONTRACTS

- A court of equity, not law – doing what is "fair and reasonable"
- Rejecting (voiding) "executory" contracts
- Impairing contracts – discounting the principal debt, rewriting terms, changing collateral, extending amortization

BANKRUPTCY POWER TO AVOID "POISON PILLS"

- **Post-petition creditor techniques to mitigate bankruptcy consequences**
  - **Springing liens**
  - **Declaring default and accelerating the debt**
  - **Imposing penalty interest, charges**
  - **Prohibiting exercise of bankruptcy powers**
- **Bankruptcy law allows court to disregard these post-petition actions**

UNDERSTANDING PENSION OBLIGATIONS



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PUBLIC PENSION OBLIGATIONS – WHICH RELATIONSHIP IS CONTRACTUAL?

- **Between the employer and the employee?**
  - **"Vested rights" principle**
- **Between the employer and the pension fund?**
- **Between the pension fund and the employee?**

PUBLIC PENSION OBLIGATIONS – STATUTORY OR CONTRACTUAL?

CALIFORNIA EXAMPLES

- CalPERS
  - State agencies - statutory
  - Contract agencies - contractual
- CalSTRS
  - School districts - statutory
  - Charter schools - contractual
- County Systems
  - Counties - statutory
  - Districts - contractual
- Charter cities, special districts - both

PUBLIC PENSIONS – CAN THEY BE REJECTED?

- Can only be rejected (voided) if "executory" contracts
  - Classic – commercial leases, purchase and sales contracts, supply contracts
  - Collective bargaining agreements also can be rejected in Ch. 9 (*Vallejo*; *Orange County*)
    - Must balance hardships and equities, follow good faith negotiations and serve policy of rehabilitation
  - BUT: Are pension contracts "executory"? Do <u>both</u> parties still have obligations to perform?

PUBLIC PENSIONS – CAN THEY BE IMPAIRED?

- All contracts can be impaired if the municipal debtor proposes that treatment in the Plan
- The Court can't force the debtor to propose impairing pensions, but can refuse to confirm a Plan

CHAPTER 9 PLANS OF ADJUSTMENT

- Purpose – fresh start
- Disclosure statement is the "prospectus"
- Plan is the "offering"
- Classification and treatment of claims – by types
- Majority vote of each "class" must approve (or be "crammed down")
  - Vote tallied by # of claimants and $ of claims
- Plan must be in the best interest of creditors, feasible and not likely to fail

A TALE OF THREE CITIES

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DETROIT

- Fiscal collapse
- State takeover of city administration
- Threats, fears, compromises
- Court ruling: Vested contract rights to pensions not protected in Bankruptcy Court
- Could have been protected if had written the state Constitution differently
- Plan confirmed with affirmative vote of retirees accepting treatment under the Plan

STOCKTON

- Met State gatekeeper requirements (Govt. Code 53670) – negotiated with creditors, mediator
- Satisfactory resolution of nearly all creditors' claims
- Cuts in retiree medical benefits
- Voter-approved tax increase
- Kept CalPERS current on contributions
- Plan did not propose to impair pension
- Single objecting creditor – undersecured bondholder

STOCKTON – THE PLAN CONFIRMATION FIGHT

- Was Franklin fairly classified?
- Was plan fair and reasonable to Franklin?
- Could CalPERS' claims be impaired in Chapter 9?

STOCKTON – THE RULINGS

1. The unfunded liability is a debt owed by the City to its retired employees
2. CalPERS is not the holder of the pension claims, the retirees are (thus, thousands of claims for hundreds of millions of dollars); CalPERS bears no risk, has no "standing" to complain
3. The claims are contractual – from the contract between the City and its former employees
4. The City has a minor administrative contract with CalPERS to benefit former employees, and that contract could be rejected in Ch. 9

STOCKTON – THE RULINGS

5. All of CalPERS' "poison pills" (prohibition on impairment, acceleration, statutory liens) fail under the Supremacy Clause and Bk Code
6. Pensions are not an exercise of "political or governmental powers" reserved to the states – just a commercial choice available to the City
7. Pensions are not protected in federal bankruptcy by the "vested rights" doctrine – *Congress* can impair contracts and does so regularly under the Bankruptcy Code

STOCKTON – CONCLUSION

"As long as California authorizes its municipalities to be debtors in cases under Chapter 9 of the Bankruptcy Code, municipal contracts may be impaired by way of a confirmed Chapter 9 plan of adjustment of municipal debts."

- **BUT: The Court confirmed Stockton's Plan anyway, without impairing pensions. Found it feasible and in the best interest of creditors**
- **Franklin treated fairly; retirees giving up far more than Franklin**

STOCKTON – SOME OBSERVATIONS

- An intemperate ruling?
- CalPERS branded a "bully"
- Perception of employee influence over CalPERS' Board
- Heavy-handed "poison pills"
- Franklin's intransigence; other creditors cooperated
- Hostility toward the CA's "rigid" vested rights doctrine
- Court frustration over parties' failure to compromise

BEYOND DETROIT AND STOCKTON

- Next up, San Bernardino
- Practical issues for financially troubled municipalities seeking refuge in Chapter 9
- Further erosion of the "vested rights" doctrine?
- Classification of claims may be ultimate poison pill – retirees' claims will always swamp number and amount of all other unsecured debts
- Legislative proposals to narrow the gateway into Chapter 9 (but see Illinois and New Jersey!)

A FINAL WORD ABOUT THE PRICE TAG…

"Would everyone check to see they have an attorney? I seem to have ended up with two."

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