Very Good Debates

Mitchell Ryan, Moderator
Rust Omni; Orange, Calif.

Judicial Debate

Resolved: *Bankruptcy Code § 307 and the corresponding Federal Rules of Bankruptcy Procedure should be amended to permit the court to limit the role of the U.S. Trustee in corporate chapter 11 cases for cause upon motion of an official committee of unsecured creditors appointed in the case.*

Pro: Hon. Peter W. Bowie
U.S. Bankruptcy Court (S.D. Cal.); San Diego

Con: Hon. August B. Landis
U.S. Bankruptcy Court (D. Nev.); Las Vegas

Business Debate

Resolved: *Municipalities should not be permitted to modify pension benefits in chapter 9.*

Pro: Sharon L. Levine
Lowenstein Sandler LLP; Roseland, N.J.

Con: James H.M. Sprayregen
Kirkland & Ellis LLP; Chicago

Consumer Debate

Resolved: *Trustees should not be permitted to sell property where there is no equity for the estate.*

Pro: C.R. "Chip" Bowles, Jr.
Bingham Greenebaum Doll LLP; Louisville, Ky.

Con: Ford Elsaesser
Elsaesser Jarzabek Anderson Elliott & Macdonald, Chtd.; Sandpoint, Idaho

KIRKLAND & ELLIS

Resolved: Municipalities Should Not be Permitted to Modify Pension Benefits in Chapter 9

Outline of "Con" Arguments[1]

The resolution as posed is false. Municipalities should be permitted (indeed, in most cases they should be required) to modify public pension obligations—like any other obligations—in Chapter 9 proceedings.

The question up for debate is whether current law permits the modification of public pension obligations through a chapter 9 municipal bankruptcy proceeding. The answer is clearly "yes." Neither of the arguments typically raised in by unions and pension fund participants to the contrary

—that (1) Chapter 9 of the United States Bankruptcy Code is somehow unconstitutional; and (2) various state constitution "pension clauses" prohibit pensions modification inside or outside of bankruptcy—pass muster.

***First*,** there is no authority suggesting that Chapter 9 of the bankruptcy code is unconstitutional merely because it permits a municipality to impair contracts. United States Supreme Court authority comes to the opposite conclusion: when a municipality files bankruptcy case, any "impairment" occurs by order of court, not by act of state, and thus Chapter 9 does not create "contracts clause" issues at all.[2] Regardless, if a "contracts clause" obstacle did exist, a state's police power is a well-established exception to the "contracts clause" and has been routinely applied to permit municipalities to impair contracts when necessary and reasonable to fulfill a legitimate state purpose.[3] A state's choice to adopt Chapter 9, permitting municipalities to (where appropriate) seek bankruptcy protection, is such a purpose.

Second, state constitutional "pension clauses" do not change

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1 The authors of this outline are attorneys at Kirkland & Ellis LLP ("K&E"). The content is for argument purposes in this ABA debate only and should not be attributed to any K&E clients.

2 *United States v. Bekins*, 304 U.S. 27, 54 (1938)

3 *See, e.g., Hernandez v. Commonwealth*, 2013 WL 3586616 (P.R. June 24, 2013); *United Auto., Aerospace, Agric. Implement Workers of Am. Int'l Union v. Fortuno*, 633 F.3d 37 (1st Cir. 2011); *Buffalo Teachers Fed'n v. Tobe*, 464 F.3d 362 (2d Cir. 2006); *Baltimore Teachers Union v. Mayor and City Council of Baltimore*, 6 F.3d 1012 (4th Cir. 1993).

the equation. These clauses merely elevate pension claims to the status of contractual claims, and indeed the clauses were passed because most states historically held that pension claims did not enjoy contractual status. While the clauses may prevent a state from breaching such obligations in the ordinary course, the bankruptcy code trumps the contracts clause (and the "pension clauses") in the ordinary course.

The bottom line is that a state has a right to adopt, or not, chapter 9, but cannot pick and choose priority levels if it elects to adopt chapter 9. In other words, if a state adopts chapter 9, it cannot isolate any set of claims from impairment, but must treat all claims

—including those based on public pensions—fairly and equitably.

1. **Chapter 9 Is Constitutional**

(a) **The "Contracts Clause" Does Not Apply**

(i) The only argument asserted against Chapter 9's constitutionality is that it supposedly "end runs" the U.S. Constitution's "Contracts Clause," which by its terms provides that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts . . . ."[4] But the Contracts Clause clearly did not bar the enactment of Chapter 9 in general, nor does it prevent the use of Chapter 9 in particular matters where public pensions are impaired as part of a plan of adjustment.

(ii) For one thing, the Constitution itself expressly authorized Congress to enact "uniform Laws on the subject of Bankruptcies throughout the United States."[5] As the Supreme Court has held repeatedly, through this explicit provision in Article I, the framers of the Constitution "expressly vested" Congress "with the power of passing bankrupt laws" and did not bar Congress from "from passing laws impairing the obligation of contracts"; Congress "may, consequently, pass a bankrupt law which does impair [contracts]."[6]

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4 U.S. CONST. art. I, § 10, cl. 1.

5 U.S. Const. art. I, § 8, cl. 4

6 *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 191 (1819); *see also Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188 (1902).

(iii) Chapter 9 is precisely the type of "uniform law on the subject of Bankruptcies" that the framers of the Constitution envisioned in Article I. Under the Congressionally-passed scheme, a federal bankruptcy court—***not the state***—impairs contracts as part of a court-approved plan of adjustment, even though states must consent by statute to the initial commencement of bankruptcy cases by municipalities.[7] In other words, it is the Bankruptcy Court's order as part of a plan of adjustment, not any act of state in particular or certainly the enactment of Chapter 9 in general, that "impairs" any contract or modifies any public pension benefits.

(iv) Thus, the Supreme Court specifically held in *United States v. Bekins* that contracts clause and related protections do not pose any obstacle to the authorization and maintenance of a municipal bankruptcy case, even though as part of such a proceeding contractual obligations may be impaired by order of a federal bankruptcy court.[8]

(v) *Bekins* is right on point for this debate. There, the objecting creditors argued that California's consent to municipal bankruptcy would be inconsistent with the California Constitution's "contracts clause." The Supreme Court squarely rejected that argument, holding that even though the municipal debtor and the State of California *themselves* could not impair the municipality's debts, they nonetheless could call in the bankruptcy court to provide the "needed relief."[9]

(vi) Nothing has changed since *Bekins*, and the logic is inescapable. Chapter 9 of the Bankruptcy Code was passed by Congress pursuant to Article I of the United States constitution, which directly authorized Congress to pass uniform laws on bankruptcies throughout the United States. Congress expressly complied with the Tenth Amendment to the Constitution by only applying Chapter 9 of the Bankruptcy Code to those states that expressly and voluntarily adopt it by statute. There is no constitutional problem in applying

7 *Bekins*, 304 U.S. at 54.

8 *Id.*

9 304 U.S. at 54.

Chapter 9's terms to those states that choose to adopt it.

(b) **The "Police Powers" Doctrine Is In Any Event A Well-Settled Exception To The Contracts Clause That Would Embrace Passage Of Chapter 9**

(i) The "police power" is a well-settled exception to the constitutional proscription against impairing contracts.[10] Numerous federal and state courts have recognized that a state's police power allows it to impair contracts in order to avert a fiscal emergency.[11] Essentially, the police powers doctrine recognizes that every contract with a public body contains an implied provision providing that municipality has a reserved power to impair the agreed-upon deal in certain circumstances.

(ii) As these authorities make clear, impairment of a public contract is justified by the police power if ***reasonable and necessary*** to serve an ***important public purpose***.[12] The "reasonableness" inquiry asks whether the law is "reasonable in light of the surrounding circumstances," and the "necessity" inquiry focuses on whether a state "impose[d] a drastic impairment when an evident and more moderate course would serve its purposes equally well."[13] The "important public purpose" requirement is satisfied where the leg-

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10 *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 22 (1977) ("The States must possess broad power to adopt general regulatory measures without being concerned that private contracts will be impaired, or even destroyed, as a result."); *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 435 (1934) ("the reservation of essential attributes of sovereign power is also read into contracts as a postulate of the legal order.").

11 *See, e.g., Blaisdell*, 290 U.S. 398; *United Auto., Aerospace, Agric. Implement Workers of Am. Int'l Union v. Fortuno*, 633 F.3d 37 (1st Cir. 2011); *Buffalo Teachers Fed'n v. Tobe*, 464 F.3d 362 (2d Cir. 2006); *Baltimore Teachers Union v. Mayor and City Council of Baltimore*, 6 F.3d 1012 (4th Cir. 1993); *Subway-Surface Supervisors Ass'n v. N.Y. City Transit Auth.*, 375 N.E.2d 384 (N.Y. 1978).

12 *U.S. Trust*, 431 U.S. at 25; *Baltimore Teachers Union*, 6 F.3d at 1015.

13 *U.S. Trust*, 431 U.S. at 31; *see also Fortuno*, 633 F.3d at 45-46.

islation in question was "aimed at remedying an important general social or economic problem rather than providing a benefit to special interests."[14]

(iii) Courts consider an "impairment" to be reasonable and necessary where the state did not (a) consider impairing the contracts as a solution that was on pay with other policy alternatives (*i.e.*, impairing contracts should not be a more politically expedient alternative such as raising taxes or cutting services); (b) impose a drastic impairment when an evident and more moderate course could address the financial emergency; or (c) act unreasonably in light of the surrounding circumstances.[15]

(iv) Courts typically defer to a legislature on whether a piece of legislation is reasonable and necessary to serve an important public purpose.[16] And once a legislature enacts a law it believes is required by the police powers, the burden is on those challenging the law to show that the legislation is unreasonable or unnecessary.[17]

(v) There is no serious question that the enactment of Chapter 9 in general, or that state enactments of eligibility statutes, would satisfy the provisions of the well-settled police powers doctrine. Where a municipality is in a condition such that it must seek bankruptcy protection, doing so would by definition be necessary and reasonable to achieve an important public purpose.

2. **State "Pension Clauses" Do Not Bar The Operation Of Chapter 9**

(a) The next argument asserted in favor of the resolution is that state constitutional "Pension Clauses" bar the impairment of

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14 *See Buffalo Teachers Fed'n*, 464 F.3d at 368 (internal quotation omitted).

15 *Buffalo Teachers*, 464 F.3d at 371 (*citing U.S. Trust Co.*, 431 U.S. at 30–31); *Fortuno*, 633 F.3d at 45–46;

16 *U.S. Trust*, 431 U.S. at 23, 26; *Baltimore Teachers Union*, 6 F.3d at 1019.

17 *Fortuno*, 633 F.3d at 44-45.

public pension obligations within the confines of a Chapter 9 proceeding.[18] For a wide variety of reasons, some of which are similar to those described above, state "Pension Clauses" do not and cannot bar the operation of Chapter 9.

(b) ***First***, for the same reason that the Contracts Clause does not bar Chapter 9 in general, "Pension Clauses" do not bar any particular activity within a Chapter 9 case. The Pension Clauses are powerful for one reason: they turn pension-based obligations into "contractual obligations," which prior to the enactment of the clauses they were not. But the Pension Clauses also specify that their protections are against diminishment or impairment *by the State*. None of the Pension Clauses prohibit impairment of public pension rights by a federal bankruptcy court—the same limitation that was crucial to the Supreme Court in *Bekins*. Thus, a finding that Chapter 9 is constitutional because contractual "impairment" is done by a federal bankruptcy court rather than the "State" (as the Supreme Court made clear in *Bekins*) is dispositive of this argument, and requires a finding that bankruptcy court modifications of pension obligations through a plan of adjustment are not State "impairment" or "diminishment" of pension obligations at all.[19]

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18 These clauses (the "Pension Clauses") aren't identical, but Michigan (a state that has adopted Chapter 9) and Illinois (a state that has not yet done so) present illustrative examples. Michigan's pension clause states that "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." MICH. CONST. art. IX, § 24, cl. 1. Illinois's pension clause states that participation in a public pension system is "an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." ILL. CONST. 1970, art. XIII, § 5.

19 *E.g., In re Jefferson County, Ala.*, 484 B.R. 427, 460 (Bankr. N.D. Ala. 2012) (noting that Chapter 9 debtors are not "officer[s] of the bankruptcy court"); *Matter of Sanitary & Imp. Dist., No. 7*, 98 B.R. 970, 973 (Bankr. D. Neb. 1989) ("[T]he Bankruptcy Code adopted pursuant to [the Bankruptcy Clause] permits the ***federal courts through confirmation of a Chapter 9 plan to impair contract rights*** of [creditors] and that such impairment is not a violation by the state or municipality of [the Federal Contracts Clause] which prohibits a state from impairing

(c) Indeed, this argument on its face proves too much. If a Pension Clause barred the modification of public pension obligations in bankruptcy, *all* authorizing statutes would be invalid—and chapter 9 would be a nullity— because *all* Chapter 9 cases contemplate the impairment of obligations in a manner that would be, were this argument correct, in "violation" of the federal (and, where, applicable, state) Contracts Clauses. That, as the Supreme Court has held, and no court has disputed, is not the law.

(d) ***Second***, by their express terms, the Pension Clauses were enacted to extend the protection of the Contracts Clause to pension obligations, which had previously been treated as non-contractual gratuities. The plain terms of the Clauses require this interpretation—they explicitly provide that pension obligations shall be "contractual obligations." The Clauses do not say that pension obligations are absolute. If the framers of the State constitutions wanted these obligations to be absolute, they would have said so. Instead, the framers said that pension obligations are "contractual obligations" (Michigan) or "enforceable contractual obligations" (Illinois). The language of the state constitutions means what it says; to excise the "contractual" language from State constitutions is to re-write them.

(e) In any event, because the Pension Clauses merely bring pensions within the protections of the Contracts Clause, the debate ends there. It is beyond dispute that the Bankruptcy Code abrogates the protections of the Contracts Clauses.[20]

(f) Finally, the proponents of the resolution contend that a municipality that files Chapter 9 intending to seek the reduction of public pension benefits is ineligible because it seeks to do something that is prohibited by State law (i.e. a Pension Clause). This argument conflates two separate acts—the *filing* of a Chapter

such rights.") (emphasis added).

20 *See, e.g.*, *In re City of Stockton, California*, 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012) ("In sum, even if the plaintiffs' [pension] benefits are vested property interests, the shield of the Contracts Clause crumbles in the bankruptcy arena."); *In re City of Colorado Springs*, 187 B.R. 683, 691 (Bankr. D. Colo. 1995) (noting that binding holdouts is "consistent with the constitutional authority of bankruptcy courts to impair contractual obligations").

9 petition (which must be expressly authorized by State law) and submission of a plan of adjustment (in which the Court would actually affect pension benefits). The fact that a city plans to seek to compromise all obligations (including pension obligations) through a plan does not make it ineligible where (as, for example, in Detroit) state law expressly made it eligible.

(g) Thus, courts have held that section 943(b)(4) of the Bankruptcy Code permits the terms of a plan to violate state law as long as the municipality complies with state law going forward.[21]

(h) Despite the assertions made by the proponents of the resolution, nothing in the legislative history of Chapter 9 can reasonably be said to alter these conclusions. In particular, the proponents of the resolution rely on a "Senate Conference Report on H.R. 10624" to assert that Congress sought to specifically protect pension rights protected via state constitutions when it enacted what ultimately became chapter 9. Not so.

(i) As a threshold matter, the Senate Report on the 1976 amendments (collectively, the "1976 Amendments") to what was then Chapter IX of the Bankruptcy Act and ultimately enacted through Public Law No. 94-260, was limited to a report from the Senate Judiciary Committee (and not a "Conference Report").[22] That report makes no mention of state or municipal pension rights or the treatment of municipal pension obligations under the 1976 Amendments—nor does the House Judiciary Committee Report[23] or the Confer-

21 *See Columbia Falls*, 143 B.R. at 760 ("Section 943(b)(4) does not prevent the debtors from proposing a plan that impairs the rights of [creditors]."); *Sanitary & Imp. Dist., No. 7*, 98 B.R. at 974–75 (holding that a plan was unconfirmable because the terms of new bonds issued under the plan violated state law on a going forward basis but noting that the goal of chapter 9 would be defeated if state laws preventing impairment of obligations were applicable to a plan)

22 See S. Rep. 94-458 (1975). The Senate Report was not included in the materials compiled in the United States Code and Administrative News.

23 See H.R. Rep. 94-686 (1975), reprinted in 1976 U.S.C.C.A.N. 539, 539–583.

ence Committee Report[24] published in connection with the 1976 Amendments.

(ii) Rather, the reported legislative history from the Senate cited in favor of such enhanced protections is limited to floor debate occurring on March 25, 1976 between Senator Roman Hruska, a manager of the 1976 amendments, and Senator Jacob Javits. Even assuming that single debate is indicia of legislative intent (which it is not), a close reading of the Congressional Record identifies no intent by Congress to set aside a municipal debtor's rights in favor of state pension law.

(iii) The statement in question arose from a question posed by Senator Javits as to "what happens to the individual pensioner of the subdivision of a State or of a State itself, or the one whose rights have been vested for a pension under State law or appropriate local law," such as in New York, where municipal employees' pension rights are protected by the New York state constitution.[25] Senator Hruska replied: "The due process clause of the U.S. Constitution, of course preserves the rights of a person which have become vested in his pension plan, if the pension plan is fully executed. Under New York law, it would be, at the very least, a paramount claim on any assets of the bankruptcy [sic]."[26] Notably, Senator Hruska did not suggest that state pension law would override a municipal debtor's rights or prevent the municipal debtor from modifying or impairing vested pension benefits. Rather, Senator Hruska stated only that municipal pensioners would hold "a paramount claim on any assets of the bankruptcy [sic]"—and even then, only with respect to vested pension benefits. In other words, municipal pensioners would hold claims against the municipal debtors, but the pensions themselves would not be immune from modification.

(iv) Nor can it be argued that the legislative history to the 1976 Amendments indicates in any way Congress's intent

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24 See H.R. Rep. No. 94-938 (1976) (Conf. Rep.), reprinted in 1976 U.S.C.C.A.N. 583, 583–592.

25 122 Cong. Rec. S4376 (March 25, 1976).

26 Id. at S4377.

to adopt in any way views expressed by the American Federation of State, County and Municipal Employees ("AFSCME"). Congressman Herman Badillo of New York did cause a report prepared on behalf of AFSCME from New York City to be included in the Congressional Record for the floor debate on the 1976 Amendments undertaken by the House of Representatives.[27] But a memorandum submitted on behalf of such obviously parochial interest cannot be evidence of legislative intent—even if it were possible to disregard the absence of any such record in the Senate's own legislative record.

(v) Such matters are particularly relevant with respect to the legislative history of the 1976 Amendments. Concerns that "representatives of one or more municipal employee unions of the City of New York" were attempting to influence the legislative record outside the deliberative process motivated certain Congressmen to clarify the official legislative record by including a supplement to the House Report.[28] Thus, the House Report includes "Supplemental Views" of certain Congressmen as an addendum.[29] That addenda makes clear that the legislative record with respect to the 1976 Amendments should in no way be construed as limiting Chapter 9's application in favor of state's rights or endorsing the AFSCME memorandum. In particular, these Congressmen made clear that that municipal bankruptcy as modified by the 1976 Amendments would implicate the full scope of Federal preemptive power under the Commerce Clause in large scale municipal bankruptcy practice.[30] Their

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27 See 122 Cong. Rec. H2381–H2384 (March 25, 1976).

28 Supplemental Views of Messrs. Butler, Kindness, Hutchinson, McClory, Moorhead of California, and Hude, with Mr. Wiggins Concurring in Part and Dissenting in Part, reprinted in 1976 U.S.C.C.A.N. 577, 577 ("Congressional Supplement").

29 Id. at 577–8.

30 See Congressional Supplement, 1976 U.S.C.C.A.N. at 582 ("The legitimate impact on commerce caused by the bankruptcy of a major municipality justifies use of the commerce power to infringe on State sovereignty by allowing the rejection of executory contracts . . . . While it may be argued that these powers may impair State sovereignty beyond the scope of the bankruptcy power, they are clearly constitutional

"Supplemental Members" anticipated the Supreme Court's own jurisprudence in Garcia v. San Antonio Metropolitan Transit Authority,[31] and its progeny—which leave no doubt that questions of state sovereignty must yield to matters affecting national commerce, particularly where the Bankruptcy Clause is also at issue.[32]

(vi) Moreover, that same floor debate led by Senator Hruska, cited as somehow favoring Tenth Amendment rights in derogation of Chapter 9 on account of Senator Hruska's debate with Senator Javits, also saw pointed debate on a municipal debtor's rights to reject collective bargaining under the 1976 Amendments. Senator Hruska, in floor debate with Senator Quentin Burdick (a floor manager for the 1976 Amendments) made clear that, by a rejecting a municipal collective bargaining agreement, a municipal debtor/employer would be completely absolved of any duties to bargain that might otherwise arise under state law: "In any case where the labor laws conflict with the powers of the petitioner under this Act, it is the intent of the legislation that the Federal, State, and local labor laws should be overridden. I want to make it clear that [the bankruptcy court] will not be obligated to follow state or local law in that regard."[33]

(vii) In sum, the legislative record when read in its entirety confirms that state labor laws must yield to the municipal debtor's rights to reject its contracts—including collectively bargained contracts. And nothing within the legislative record seriously undermines the reality that Congress intended all benefits, including otherwise vested benefits, to be subject to compromise in a municipal bankruptcy in states which elected to adopt Chapter 9.[34]

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under the commerce power.").

31 469 U.S. 528 (1985)

32 Cf. Central Virginia Community College v. Katz, 546 U.S. 356 (2006).

33 See 122 Cong. Rec. at S4377. See generally Ryan Preston Dahl, Collective Bargaining Agreements and Chapter 9 Bankruptcy, 81 Am. Bankr. L.J. 295, 323–329 (2007) (analyzing legislative history to the 1976 Amendments).

34 See In re City of Stockton, 478 B.R. 8 (Bankr. C.D. Cal. 2012).

3. Once They Elect Chapter 9, States Must Treat Public Pension Obligations Like Any Other Obligations

(a) Once a state "opts in" to chapter 9, it may *not* "pick and choose" the substantive provisions of chapter 9 that apply or shield certain creditors from impairment.[35] .

(b) States certainly have the power to prevent its municipalities from filing for chapter 9.[36] But that option comes at the cost of depriving municipalities of the ability to bind holdout creditors and obtain a discharge of their obligations.[37] States *cannot* take advantage of the ability to bind holdout unsecured creditors through chapter 9 while shield favored classes. Accordingly, in most circumstances a plan of adjustment *must* impair pension

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35 *See, e.g.*, *Stockton*, 478 B.R. at 16 ("A state cannot rely on the § 903 reservation of state power to condition or qualify, *i.e.*, to 'cherry pick,' the application of the Bankruptcy Code provisions that apply in chapter 9 cases after such a case has been filed."); *In re City of Stockton, Cal.*, 475 B.R. 720, 727 (Bankr. E.D. Cal. 2012) ("The state is the chapter 9 gatekeeper by virtue of § 109(c)(2). But that gatekeeping function ends once the gate is opened and a chapter 9 case is filed."); *In re County of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996) ("[The State] must accept chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest. The right to a discharge is not a benefit without burdens."); *In re Quality Holstein Leasing*, 752 F.2d 1009, 1014 n. 10 (5th Cir. 1985) ("State law defining property rights may not, of course, go so far as to manipulate bankruptcy priorities."); *In re City of Columbia Falls, Mont., Special Imp. Dist. No. 25*, 143 B.R. 750, 759–61 (Bankr. D. Mont. 1992) (holding that debtor could impair bonds in chapter 9 case notwithstanding state law prohibiting such impairment); *Mission Independent School Dist. v. State of Texas*, 116 F.2d 175, 177 (5th Cir. 1940) (holding that a state law provision that would operate to preclude impairment of bonds held by Texas, while allowing impairment of other bonds, was unenforceable).

36 *See, e.g.*, *In re City of Harrisburg, PA*, 465 B.R. 744, 765 (Bankr. M.D. Pa. 2011) (finding that Harrisburg was not eligible for chapter 9 relief because of a state statute that prohibited certain cities, including Harrisburg, from filing).

37 *See* 11 U.S.C. § 903(1)-(2) (providing that state debt composition laws cannot bind nonconsenting creditors).

claims to be confirmable.[38]

38 *See In re City of Colorado Springs Spring Creek Gen. Imp. Dist.*, 187 B.R. 683, 689 (Bankr. D. Colo. 1995) (noting that unjustified, disparate treatment of claims will render a plan unconfirmable); *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 34–35 (Bankr. D. Colo. 1999) (noting that a plan, to be feasible, must provide for payments under the plan and provision of services).

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Resolved: Municipalities Should Not be Permitted to Modify Pension Benefits in Chapter 9

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I. Facial Constitutionality of Chapter 9

A. Before considering whether municipalities should be able to modify pension benefits in chapter 9, consider, in the first instance, whether chapter 9 itself is facially Constitutional.

B. Constitutionality of Chapter 9 – Article I Challenge

1. Does Congress have the power under Article I of the Constitution to enact legislation affording the States the means to "end-run" the prohibitions of the Federal Constitution's Contract Clause? The language and structure of Article I, § 10 appear to indicate the answer is "no."

2. Until recently, since the 1938 case *United States v. Bekins*, 304 U.S. 27, (1938) upheld the Municipal Corporation Bankruptcy Act (a precursor to the current chapter 9 regime) over objections that the statute violated the **Tenth Amendment**, no party has challenged the constitutionality of chapter 9. This changed in the *Detroit* bankruptcy eligibility trial (and appeals of such trial, which appeals are still pending as of the date of authorship of these materials).

3. Congress first legislated in the municipal distress area in 1934 during the Great Depression, through an amendment to the federal Bankruptcy Act providing for municipal bankruptcy filings. This inaugural, 1934 municipal bankruptcy law was struck down by the Supreme Court as infringing unduly on state sovereign interests protected by the Tenth Amendment to the Federal Constitution. *See Ashton v. Cameron Cnty. Water Improvement Dist.*, 298 U.S. 513 (1935).

4. Congress responded to the financial distress of municipalities and to the *Ashton* decision by enacting, in 1937, a second set of amendments to the federal Bankruptcy Act providing for municipal bankruptcy filings. This time, Congress' municipal bankruptcy law was upheld by the Supreme Court against a facial Tenth Amendment challenge in *United States v. Bekins*, 304 U.S. 27 (1938).

5. The objectors to the municipal bankruptcy filing in *Bekins* were bondholders who challenged Congress' new municipal bankruptcy statute not only on Tenth Amendment grounds, but also on Fifth Amendment grounds which the *Bekins* Court rejected. Critically, the bondholders did not challenge the new statute on Article I grounds. The *Bekins* Court concluded that Congress' "carefully drawn" redo of its previously-invalidated municipal bankruptcy law did not "impinge upon" state sovereignty in violation of the Tenth Amendment. The *Bekins* Court saw that law, not as some unwanted affront to the States and their sovereign interests, but as a much-desired act of congressional assistance to the States, who are prohibited by the Contract Clause in the Federal Constitution from enacting their own legislation providing debt adjustment relief to their own municipalities

6. Today's version of municipal bankruptcy, now codified in chapter 9 of the Bankruptcy Code, has the same purpose as the 1937 municipal debt adjustment law:

to give the States a license and a vehicle to accomplish indirectly a result—the adjustment of their municipalities' contractual debts in a federal bankruptcy proceeding in accordance with a state-authorized and state-proposed plan of adjustment—that the Contract Clause in Article I, § 10 of the Federal Constitution prohibits the States from accomplishing directly through state legislation.

7. Article I of the Federal Constitution defines and delimits the powers of Congress. It is divided into ten separate sections, and the Contract Clause appears in the last of those sections, § 10. Article I, § 10 is, in turn, divided into three separate subsections, which read in full as follows (with emphases appropriate to the matter at hand added):

> [1] *No State shall* enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; *pass any* Bill of Attainder, ex post facto Law, or *Law impairing the Obligation of Contracts*, or grant any Title of Nobility.
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> [2] No State shall, *without the Consent of the Congress*, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing it's inspection Laws; and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States; and all such Laws shall be subject to the Revision and Controul of the Congress.
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> [3] No State shall, *without the Consent of the Congress*, lay any Duty of Tonnage, keep Troops, or Ships of War in time of Peace, enter into any Agreement or Compact with another State, or with a foreign Power, or engage in War, unless actually invaded, or in such imminent Danger as will not admit of delay.

8. By this language, including the distinctions between subsections [1] ("No State shall") and [2] and [3] (which allow Congress, with its consent, to relieve States of the requirements imposed in those subsections), the Framers of the Constitution intended to deny, and did deny, Congress the power to enact legislation the purpose and effect of which is to afford the States the means to "end-run" the prohibitions imposed upon them by the Contract Clause in subsection [1] of Article I, § 10. Because that is precisely what the purpose and effect of chapter 9 is, chapter 9 is in excess of Congress' Article I powers and must be struck down as facially unconstitutional. The drafting history of Article I also supports the conclusion that the prohibition on State action to impair contracts (including pensions) with consent of Congress was to be "absolute" and without any consent of Congress exception. See M. Farrand, THE RECORDS OF THE FEDERAL CONVENTION OF 1787 ("Convention Records"), Vol. II, at 439 n.14 & 442 n.26 (Yale Univ. Press 1911); *cf. Rhode Island v. Massachusetts,* 37 U.S. 657, 724-25 (1838) ("By the first clause of the tenth section of the first article of the constitution, there was a positive prohibition against any state entering into 'any treaty, alliance, or confederation.:' *no power under the government could make such an act valid, or dispense with the constitu-*

tional prohibition.") (emphasis added).

9. Accordingly, Article I, read as an integrated whole, denies Congress the power to enact legislation, such as chapter 9, which has the purpose and effect of relieving the States of the prohibitions imposed on them by the Contract Clause in Article I, § 10 subsection [1].[1]

II. Modifying Pensions in Chapter 9

A. Assuming, without deciding, the Constitutionality of chapter 9, the bottom line question is whether Congress intended, in enacting chapter 9, to allow States (and their political subdivisions) the ability to diminish pension rights, and specifically in States (including Michigan) which provide near-absolute language in State Constitutional provisions protecting pensions from diminishment or impairment? We again believe the answer should be "no".

B. Before analyzing the specific Bankruptcy Code and State Constitutional provisions, it bears noting that the 1976 Senate Conference Report discussing amendments to the Bankruptcy Code and the enactment of chapter 9 focused on the provision, now codified at 11 U.S.C. § 903, preserving the authority of State law to control municipal powers, including expenditures. While the report suggested on the one hand that state labor law would not prevent the rejection of all CBAs in bankruptcy, it also confirmed that state law nevertheless continues to protect pension rights from discharge under the Bankruptcy Code as AFSCME has argued. *See* Senate Conference Report on H.R. 10624.

C. In the report, Senator Javits (R-NY) sought and obtained from Senator Burdick (D-ND) confirmation that "the right of an individual pensioner drawing his pension . . . will not be subjected to the Bankruptcy Act and one whose pension is vested" by a state constitution will not be "affected by the bankruptcy" of a city. Senate Conference Report on H.R. 10624 at S4376-77. Under the New York constitutional provision at issue, similar to the "Pensions Clause" in the Michigan Constitution discussed extensively in the *Detroit* case, pension benefits "shall not be diminished or impaired." *Id.* at S4377. Consistent with the argument that such constitutional pension rights receive absolute protection akin to state property rights in bankruptcy, Senator Burdick's reply left no doubt that due process "preserves the rights of a person which have become vested in his pension plan" despite a municipal bankruptcy, and a state constitutional right to vested pension benefits "would be, at the very least, a paramount claim on any assets of the bankruptcy." *Id.* at S4377.

D. These were not theoretical questions for Senator Javits, a former bankruptcy lawyer,

1 While certain *dicta* in *Bekins* may suggest that municipal bankruptcy is constitutional, it is critical to point out and emphasis that *Bekins* was a 10th Amendment challenge to federal municipal bankruptcy legislation, and not an Article I contracts clause challenge. Thus, the *Bekins* Court did not issue any ruling controlling as a matter of *stare decisis*. While it may be unlikely that any bankruptcy court judge would actually invalidate chapter 9 on a facial constitutional challenge, the higher any appeal goes (Court of Appeals or Supreme Court level), the more likely a Court is to consider these weighty constitutional issues.

and his constituents. The magnitude of New York City's severe economic problems in 1976 prompted Congress to expedite the consideration of the amended municipal bankruptcy statute in 1976. Senator Javits was nevertheless confident that the report would "give great assurance to many employees who have served faithfully and thought they had something until they ran into the present financial problems." *Id.* at S4377

E. Under section 109(c) of the Bankruptcy Code, an entity is eligible to be a debtor under chapter 9 only if the entity:

1. Is a municipality;

2. **Specifically authorized under state law to be a debtor**;

3. Is insolvent, as defined in 11 U.S.C. § 101(32)(C);

4. Desires to effect a plan to adjust its debts; and

5. Meets one of the following requirements:

a) has obtained the agreement of creditors holding at least a majority in the amount of claims of each class that the Debtor intends to impair through its plans;

b) has negotiated in good faith but failed to obtain the agreement of creditors holding at least a majority in the amount of claims of each class that the Debtor intends to impair under its plan

c) unable to negotiate with its creditors because such efforts are impracticable; OR

d) Must reasonably believe that a creditor may attempt to obtain a preference avoidable under section 547 of the Bankruptcy Code.

F. Fifteen states specifically authorize filing of a chapter 9 bankruptcy (AL, AZ, AR, CA, ID, KY, MN, MO, MT, NE, NY, OK, SC, TX, WA).

1. Another nine states, including authorize a filing conditioned on a further act of the state, an elected official or state entity (CT, FL, LA, MI, NJ, NC, OH, PA, RI).

2. Three states (CO, OR and IL) grant limited authorization, two states prohibit filing (GA) but one of them (IA) has an exception to the prohibition.

3. The remaining 21 states are unclear or do not have specific authorization.

G. In addition to the requirement of being authorized under state law to file chapter 9, 11 U.S.C. § 943(b)(4) precludes a bankruptcy court from confirming municipality's proposed plan of adjustment if the municipality is "prohibited by law from taking any action necessary to carry out the plan." As the *Bekins* Court stated with respect to an analogous provision in chapter 9's predecessor municipal bankruptcy law, the phrase "prohibited by

law" in § 943(b)(4) of chapter 9 "manifestly refers to the law of the State." *Bekins*, 304 U.S. at 49

H. This issue of proper state authorization and the requirement that a chapter 9 Plan comply with State law is particularly crucial in states that provide constitutional pension protection:

Table 1: Constitutional Pension Protections in Seven States

State	What Does It Protect?	Year Added	Text
Alaska	Past and Future Benefits	1956	"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." (Article XII, Section 7)
Arizona	Past and Maybe Future Benefits	1998	"Membership in a public retirement system is a contractual relationship… and public retirement system benefits shall not be diminished or impaired." (Article XXIX, Section 1, Clause C)
Hawaii	Past Benefits	1978	"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." (Article XVI, Section 2)
Illinois	Past and Future Benefits	1970	"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." (Article XIII, Section 5)
Louisiana	Past Benefits	1974	"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" (Article X, Section 29, Clauses A and B)
Michigan	Past Benefits	1963	"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." (Article IX, Section 24)
New York	Past and Future Benefits	1938	"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." (Article V, Section 7)

Source: Center for Retirement Research at Boston College

I. The issue of proper state law authorization was an issue in both the *Detroit* and *Harrisburg* bankruptcies.

1. In *Harrisburg*, the Bankruptcy Court dismissed the chapter 9 case, finding lack of specific authorization for Harrisburg to file chapter 9. *See In re City of Harrisburg, PA*, 465 BR 744 (Bankr. M.D. Pa. 2011).

2. In *Detroit*, the Bankruptcy Court upheld the chapter 9 filing (which decision is currently pending on appeal) in the face of numerous challenges to both chapter 9 and the specific authorization. Parties argued that in light of the special constitutional protections provided to Detroit's pension participants under Michigan law, any filing authorized by the Governor and Detroit's Emergency Manager that failed to protect the City's pension obligations was invalid, particularly in light of statements made by the City and State that the chapter 9 case would seek to impair vested pension rights. The bankruptcy court in *Detroit* rejected these arguments and found that accrued vested pension rights could be legally impaired in chapter 9, despite the Michigan constitutional protections for such rights. This decision is currently on appeal, and this decision appears incorrect for the reasons set forth below.

J. Using the Michigan Constitution as an example, the Pensions Clause in Article IX, Section 24 of the Michigan Constitution states that: "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."

K. This language accords accrued pension benefits **absolute** protection against impairment through any means, including a city's filing and maintenance of a chapter 9 bankruptcy case; and in Tenth Amendment federalism terms, the Pension Clause thus entails an affirmative withholding of the "state consent" necessary to lawfully adjust accrued pension debts.

L. The *Detroit* bankruptcy court rejected this argument and held that the Pensions Clause was a mere contractual obligation, free to be voided in chapter 9 like other contractual obligations and/or other state "Contracts Clauses". In part, the court relied on the fact that in enacting the Pensions Clause in 1963, Michigan was aware of the possibility of municipal bankruptcy.

M. However, this reasoning is unsound and the Pensions Clause, both logically and based on relevant case law, must grant more protection to pensions than the Contracts Clause does to ordinary contracts—which is why there are two separate provisions. Pensions and ordinary contracts are fundamentally different precisely because the Pensions Clause is an "unambiguous[]" absolute, *Studier v. Mich. Pub. Sch. Emps.' Ret. Bd.*, 698 N.W.2d 350, 355 (Mich. 2005), while the Contracts Clause is not read "literal[ly]," *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 240 (1978) (internal quotation marks omitted), and is "not an absolute," *Home Bldg. & Loan, Ass'n v. Blaisdell*, 290 U.S. 398, 428 (1934).

N. Rather, the Contracts Clause "must be accommodated to the inherent police power of the State to safeguard the vital interests of its people." *Romein v. Gen. Motors Corp.*, 462 N.W.2d 555, 534 (Mich. 1990) (internal quotation marks omitted). The Arizona Supreme Court recently recognized precisely this distinction.

O. The Pensions Clause of the Arizona Constitution similarly states that "[m]embership in a public retirement system is a contractual relationship that is subject to [the Arizona Contracts Clause], and public retirement system benefits shall not be diminished or impaired." Ariz. Const. art. 29, § 1. The Arizona Supreme Court rejected the argument that the clause simply establishes contractual protection for pensions, leaving them subject to impairment as necessary noting that "accepting [that] argument would render superfluous the latter portion of…the Pension Clause, which prohibits diminishing or impairing public retirement benefits." *Fields v. Elected Officials' Ret. Plan*, --- P.3d ---- , 2014 WL 644467, at *3 (Ariz. Feb. 20, 2014). Accordingly, "the Pension Clause confers additional, independent protection for public retirement benefits separate and distinct from the protection afforded by the Contract Clause." *Id.* at *4.

P. Given these holdings, and coupled with the fact that certain public pension employees do not have ERISA or possibly even Social Security to fall back on, it is difficult to understand how the *Detroit* Court so easily concluded (wrongly, in our view) that pensions could be impaired.

Q. Finally, as to the point that the people of Michigan were aware of municipal bank-

ruptcy when enacting the Pension Clause in 1963, it is worth noting that federal law at that time did not permit the discharge of pensions in bankruptcy.

1. The Bankruptcy Act at that time allowed municipalities to discharge only "securities," meaning "bonds, notes, judgments, claims, and demands, liquidated or unliquidated, and other evidences of indebtedness, either secured or unsecured, and certificates of a beneficial interest in property." 11 U.S.C. § 402 (1958).

2. Further, as of 1963 the municipal bankruptcy statute was "virtually unused," in part because a municipality could not petition for bankruptcy unless 51 percent of creditors accepted the proposed plan of composition, and a court could not confirm a plan absent the approval of two-thirds of the creditors. 6 Collier on Bankruptcy 900.LH[4] (16th ed.).

3. So, municipalities in actuality as of the 1960's could not impair pension obligations, and as noted above, Congress did not intend to change this in 1976 when enacting chapter 9.

III. Conclusion

A. Unions and retirees in the future will continue to challenge both the constitutionality of chapter 9 and the bankruptcy court's authority to allow the impairment of vested pension benefits, particularly in states with Constitutional protection of pension benefits.

Feature

By Mark S. Kaufman and B. Summer Chandler

The Looming Chapter 9 Battle over State Protection of Vested Public Employee Pension Benefits

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For years, observers have warned of the looming threat of unfunded pension liabilities. Some dubbed the danger the "pension tsunami," and it has hit an increasing number of U.S. cities, including Vallejo, Stockton and San Bernardino in California and the city of Detroit, which have sought chapter 9 relief in bankruptcy court.[1] Despite the attention given to these cases, chapter 9 filings are relatively scarce, and many significant issues remain to be resolved by the courts. One unanswered question is whether a municipal debtor in bankruptcy can propose to pay its pension debt[2] less than in full, even when applicable state constitutional provisions provide that such obligations must not be impaired.

Defined Benefit Pension Plans and the Funding Gap

Under a "defined benefit pension plan," an employee is guaranteed a specified pension benefit upon retirement. The amount to be paid is determined by a formula that is typically based on the employee's earnings history, length of employment and age. Significantly, the ultimate payout to retirees is not based on investment returns.

Although many cities have long offered defined benefit pension plans to its employees, few have adequately saved to cover these future costs. A report released by the Pew Charitable Trusts earlier this year found that although cities have promised pensions, health care and other benefits to retirees, "few ... [have] started saving to cover the long-term costs."[3] The Pew report explains that pension underfunding occurs as a result of the "[f]ailure to faithfully pay annual retirement bills" and "when investments and other assumptions fail to meet expectations and when benefits are increased without a way to pay for them."[4] What this underfunding means, of course, is that when these obligations come due, a city might have no means by which to satisfy them.

State Constitutional Protections

The ultimate goal of a chapter 9 filing is the confirmation of an adjustment plan that implements a comprehensive restructuring proposal that is feasible — meaning not only that the plan will work in the near term, but that it will also provide the municipality with, to the extent possible, a stable financial future. Under some circumstances, a municipal debtor might determine that it is impossible to propose a feasible restructuring plan that includes the payment in full of all pension obligations owed by a city.

Many state constitutions, however, purport to protect public-sector pensions,[5] considering such obligations to be "sacred cows." Michigan's Constitution, for example, provides that pension obligations constitute "a contractual obligation ... [that] shall not be diminished or impaired."[6] Such protections lead to an inevitable question: Assuming that the necessary requisites under the Bankruptcy Code are met,[7] can the Code be used to permit a municipality to pay its pension obligations less than in full, despite state constitutional protections that provide that such rights may not be diminished or impaired?

The Detroit Example

Detroit provides a striking example of a city struggling to continue to cover current debt obligations and operating expenses while facing significant unfunded obligations to retirees. Earlier this year, **Kevyn Orr**, Detroit's emergency manager, released the City of Detroit Proposal for Creditors (the "Detroit proposal"), which recommends a plan to restructure the city's debt. Regarding the city's defined benefit pension plans, the report states that the city's unfunded actuarial accrued liability (UAAL) is significant and has likely been considerably understated. By using "more realistic assump-

1 Assuming that eligibility requirements are met, a municipality may file for bankruptcy under chapter 9 of title 11 of the U.S. Code.

2 This article will focus on pension debt as a vested, pre-petition obligation, meaning that the obligation was owed as of the date of the bankruptcy filing. Some pension obligations of this nature flow from collective-bargaining agreements, which may still be executory contracts and subject to potential rejection in bankruptcy. This article will not separately analyze those pension obligations that might be deemed a part of "rejection damages" by virtue of the rejection of a related collective-bargaining agreement as distinct from other pre-petition, accrued pension obligations. Rather, this article will address the question of whether, as a general matter, vested pension obligations may be reduced in municipal bankruptcy, similar to other pre-petition, unsecured debt obligations, where applicable state law provides that such obligations may not be impaired.

3 *A Widening Gap in Cities – Shortfalls in Funding for Pensions and Retiree Health Care*, Pew Charitable Trusts report, Jan. 2013, at 2, www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Retirement_security/Pew_city_pensions_report.pdf.

4 *Id.* at 7.

5 *See, e.g.*, N.Y. Const. art. V, § 7; Ill. Const. art. XIII, § 5.

6 Mich. Const. art. IX, § 24.

7 The standards for plan confirmation in a chapter 9 case include both the statutory requirements of 11 U.S.C. § 943(b) and those portions of 11 U.S.C. § 1129 made applicable to chapter 9 cases by 11 U.S.C. § 901(a).

tions," the analysis "suggests that pension UAAL will be approximately $3.5 billion as of June 30, 2013."[8] Under the Detroit proposal, the amount to be paid on such claims "will be substantially less than the underfunding amount, [and thus,] there must be significant cuts in accrued, vested pension amounts for both active and currently retired persons."[9]

Unions and retiree groups have voiced their staunch opposition to the proposal, arguing that the Michigan Constitution prohibits a bankruptcy filing that proposes to impair vested pension obligations. Michigan's attorney general also opposes reducing pension obligations, arguing that "a bankruptcy filing does not relieve the City and its emergency manager of their obligation to follow Michigan's Constitution. And that restriction includes the constitutional provision that prohibits a political subdivision like Detroit from diminishing or impairing an accrued financial benefit of a pension plan or retirement system."[10]

Chapter 9 and the Conflicts with State Law

Guiding principles gleaned from case law analyzing, in the chapter 9 context, the intersection of state law protections and the Bankruptcy Code suggest that state constitutional provisions that merely assert that pension obligations are contractual rights that cannot be impaired may not shield those obligations from adjustment in bankruptcy. In *In re City of Vallejo*,[11] the court considered whether a municipal debtor could reject collective-bargaining agreements without adhering to state laws. This decision provides a clear and succinct discussion of the interplay between federal and state law in the chapter 9 context. The court explained that the "United States Constitution authorizes Congress to enact uniform bankruptcy laws" and that "[b]y virtue of the Supremacy Clause, federal laws are the supreme law of the land, notwithstanding state laws to the contrary."[12] The Tenth Amendment, however, states that powers not delegated to the federal government or prohibited are "reserved to the states." "To harmonize these two competing interests — reservation of powers to the states and the supremacy of federal bankruptcy law — Congress enacted 11 U.S.C. § 903."[13] As explained by the court in *In re County of Orange*, pursuant to § 903, the court "cannot interfere with the [municipality's] ability to continue its operations or dictate what type of services or level of services the debtor municipality may provide."[14] Section 903, however, "does not provide an independent substantive limit on the application of chapter 9 provisions."[15]

The *Vallejo* court found that the city could reject its collective-bargaining agreements without adhering to state laws and explained that "Section 903, together with 11 U.S.C. § 109(c)(2), allows states to act as gatekeepers to their municipalities' access to relief under the Bankruptcy Code."[16] When a state authorizes its municipalities to file a chapter 9 petition, as is required for a municipality to be eligible to file,[17] the state "declares that the benefits of chapter 9 are more important than state control over its municipalities."[18] The court further determined that "[b]y 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."[19]

The issue of federal pre-emption in chapter 9 was recently addressed in *In re City of Stockton*.[20] In that case, retirees filed an adversary proceeding seeking injunctive relief to prevent Stockton, Calif., from unilaterally cutting retiree health benefits. Retirees asserted that they had vested contractual rights that were protected from impairment by the Contracts Clause of the U.S. Constitution, which prohibits the impairment of contracts, and by a similar clause in the California Constitution.

The bankruptcy court disagreed and denied injunctive relief. In reaching its conclusion, the court considered the retirees' assertion that their benefits were protected by the Contracts Clause of the U.S. Constitution. The court explained that the Contracts Clause bans a *state* from making a law that impairs a contract, but "does not ban Congress from making a law impairing the obligation of a contract."[21] The court further explained that "[t]he goal of the Bankruptcy Code is adjusting the debtor-creditor relationship. Every discharge impairs contracts."[22] Further, the court found that pursuant to the Supremacy Clause of the Constitution, the same analysis applies to the contracts clause in the California Constitution. Thus, the California Contracts Clause does not protect against the impairment that is authorized under the Bankruptcy Code. "In sum, even if the plaintiffs' benefits are vested property interests, the shield of the Contracts Clause crumbles in the bankruptcy arena."[23]

In the earlier case of *In re Orange County*,[24] the county alleged that it was entitled to certain proceeds held by the defendant. The defendant argued that under California law, the proceeds had been held in trust for its benefit and were not property of the county. The court held that bankruptcy law dictates whether the funds are property of the county. The court explained that under bankruptcy law, "a creditor beneficiary ... must be able to trace its funds, otherwise the funds become property of the debtor."[25]

Under California law, tracing was not required. The application of this law in bankruptcy, the court explained, would allow the state to create a special class of protected creditors in bankruptcy. The court held that "[c]hapter 9 does

8 Detroit Proposal at 24.
9 *Id.*
10 Michigan Attorney General Bill Schuette's Statement Regarding the Michigan Constitution and the Bankruptcy of the City of Detroit at 2. (Case No. 13-53846; Docket #481). Similar issues have been raised in the *Stockton* and *San Bernardino* bankruptcy cases. While this issue is currently being litigated in the bankruptcy courts, it is an issue that will likely ultimately be addressed by the U.S. Supreme Court.
11 403 B.R. 72 (Bankr. E.D. Cal. 2009).
12 *City of Vallejo*, 403 B.R. at 75.
13 *Id.*
14 *In re County of Orange*, 191 B.R. 1005, 1018 (Bankr. C.D. Cal. 1996).
15 *City of Vallejo*, 403 B.R. at 75.
16 *Id.* at 76.
17 Among other requirements, in order for a municipality to be a debtor in bankruptcy, a municipality must be authorized by the state to file for bankruptcy. 11 U.S.C. § 109(c)(2).
18 *Id.* at 76.
19 *Id.* (citing *In re County of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996)). On appeal, the district court affirmed the *Vallejo* decision and found that the California statute authorizing a municipal bankruptcy did not limit the rejection of employee contracts as a precondition to filing for bankruptcy. It also found that the state's "failure to take such action convinces this Court that the City was unequivocally authorized to exercise its right under Section 365 and reject [the agreements] without interference from the state." *In re City of Vallejo*, 432 B.R. 262, 270 (Bankr. E.D. Cal. 2010). Some argue that a state might be permitted to pre-ordain certain claims, such as pension claims, as protected from impairment in bankruptcy as a *precondition* to its granting the municipality the right to file for bankruptcy. Whether such legislation would be viewed as a legitimate attempt to circumscribe access to bankruptcy or whether, conversely, such action would be perceived as an illegitimate attempt to delimit the efficacy of chapter 9 (such that municipalities in that state might be judicially interpreted as not truly having access to chapter 9) remains to be seen.
20 2012 WL 3193588 (Bankr. E.D. Cal.).
21 *In re Stockton* at *2.
22 *Id.* at *3.
23 *Id.*
24 *In re County of Orange*, 191 B.R. 1005 (C.D. Cal. 1996).
25 *Id.* at 1015 (citations omitted).

not permit individual states to override the priority scheme that is inherent in the Code." The court further found that "simply because Congress did not incorporate § 507(a)(2) through (a)(9) into chapter 9 does not lead to the sweeping, and potentially chaotic, conclusion that Congress intended to eliminate the federal priority scheme in chapter 9."[26]

Conclusion

Several key principles emerge from these cases, which include the following:

- Congress — and not the individual states — is authorized by the Bankruptcy Clause to enact uniform bankruptcy laws, a central component of which is the impairment of contracts;
- The Bankruptcy Code establishes a federal priority scheme that is not overridden by state law in the chapter 9 context;
- Once a municipal debtor is in bankruptcy, the right to accept or reject collective-bargaining agreements is governed by federal law; and
- Although a state may control the prerequisites for permitting its municipality to file a chapter 9 case, it cannot revise chapter 9 and must accept chapter 9 in its totality.

[A] state cannot cherry-pick the Code provisions that it wishes to permit its municipalities to utilize. When it decides to permit its municipalities to file for bankruptcy protection, it must accept chapter 9 in its entirety.

Based on these guiding principles, state constitutional provisions that merely assert that accrued pension benefits are vested contractual rights and are not subject to impairment or reduction may not provide protection in chapter 9 against an attempt by a municipal debtor to pay those obligations less than in full. First, to the extent that such provisions attempt to create a special class of protected unsecured creditor that does not exist under the Bankruptcy Code, such provisions may be rejected as an improper encroachment on the federal priority scheme. Further, as repeatedly recognized by the courts, a state cannot cherry-pick the Code provisions that it wishes to permit its municipalities to utilize. When it decides to permit its municipalities to file for bankruptcy protection, it must accept chapter 9 in its entirety.

Although it is beyond the scope of this article, it bears noting that if vested pension benefits are subject to reduction in bankruptcy, the question of how such claims should be treated *vis-à-vis* other creditors and exactly what the concept of "unfair discrimination" — a standard that must be met for a plan to be approved over creditor objections[27] — should mean in this context will undoubtedly raise multifaceted and complex issues that will need to be considered and addressed.

Finally, if the courts were to rule in favor of protecting pensions, this result would mean that bondholders, believed by some to have been protected by full faith and credit, would likely be required to bear much more of the needed concessions. Such a result would likely lead to the increased cost for municipal credit, both for the restructuring municipality and otherwise. This potential eventuality highlights the tension between a state's desire to protect its public retirees on the one hand, and on the other hand, the competing consideration of the risk of seriously rising costs of municipal finance throughout the state if bondholders are required to shoulder needed concessions because reducing retiree benefits is determined to be prohibited. abi

26 *Id.* at 1021.

27 11 U.S.C. § 1129(b)(1).

Consumer Debate

Resolved: Trustees should not be permitted to sell property where there is no equity for the estate

11 U.S.C. § 326 provides:

(a) In a case under chapter 7 or 11 [11 USCS §§ 701 et seq. or 1101 et seq.], the court may allow reasonable compensation under section 330 of this title [11 ***USCS § 330] of the trustee for the trustee's services, payable after the trustee renders such services, not to exceed 25 percent on the first $ 5,000 or less, 10 percent on any amount in excess of $ 5,000 but not in excess of $ 50,000, 5 percent on any amount in excess of $ 50,000 but not in excess of $ 1,000,000, and reasonable compensation not to exceed 3 percent of such moneys in excess of $ 1,000,000, upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims..***

(b) In a case under chapter 12 or 13 [11 USCS §§ 1201 et seq. or 1301 et seq.] of this title, the court may not allow compensation for services or reimbursement of expenses of the United States trustee or of a standing trustee appointed under section 586(b) of title 28, but may allow reasonable compensation under section 330 of this title [11 ***USCS § 330] of a trustee appointed under section 1202(a) or 1302(a) of this title [11 USCS § 1202(a) or 1302(a)] for the trustee's services, payable after the trustee renders such services, not to exceed five percent upon all payments under the plan..***

(c) If more than one person serves as trustee in the case, the aggregate compensation of such persons for such service may not exceed the maximum compensation prescribed for a single trustee by subsection (a) or (b) of this section, as the case may be..

(d) The court may deny allowance of compensation for services or reimbursement of expenses of the trustee if the trustee failed to make diligent inquiry into facts that would permit denial of allowance under section 328(c) of this title [11 USCS § 328(c)] or, with knowledge of such facts, employed a professional person under section 327 of this title [11 USCS § 327]..

Section 326 expressly provides that distributions to secured creditors are to be included in calculations of compensation under section 326. However, there is a substantial line of authority,[1] however, that holds that trustees cannot be awarded fees for distributions to secured creditors from proceeds of the sales of their collateral, where the sale does not (or is not likely to) result in proceeds being made available to unsecured creditors. One of the earliest cases addressing this line of authority was *In re Lambert Implement Co.*,[2] where the court rejected the plain language of section 326 and held that, as a matter of policy, the trustee should not either: (1) enter into agreements with "fully secured creditors" to sell their collateral solely for the secured creditor's interest; or (2) sell property "where there is no potential equity for general creditors and with the trustee enhancing his compensation with no corresponding benefit to the general estate."[3] *See also* Kroop & Cosman*, Problem in the Code:, Of Bunnies and Moneys: Fixing Trustee Payment under § 326(a),* 33-6 ABIJ 44 (June 2014)(Discussing the related problem of non Money distributions)

Not every court follows the *Lambert Implement* line of cases. As discussed in *In re McCombs*,[4] other decisions[5] have determined that, under the plain language of section 326, distributions to secured creditors must be included in the section 326 calculation. These courts acknowledge the policy concerns expressed in the *Lambert Implement* line of cases, but they do not find any language in section 326 that excludes these distributions from the calculation. These courts also note that their rulings do not mean that the trustee is entitled to the full amount of compensation calculated under section 326 based on these distributions. Therefore, trustees should be aware that, when they sell property in which there is no equity, they might not receive any section 326 fees from the transaction.

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1 *See, e.g., In re* Lan Assocs. XI, LP, 192 F.3d 109 (3d Cir. 1999); *In re* Rabesh, 347 B.R. 115 (Bankr. 10th Cir. 2006); *In re* National Enter. Wire Co., 103 B.R. 56, 59 (Bankr. N.D.N.Y. 1989); *In re* Landreau, 74 B.R. 12 (Bankr. W.D. La. 1982). *See als. In re* Bob Grissett Golf Shoppes, Inc. 50 BR 598 (Bankr. ED Va 1985)(When trustee undertakes to sell fully encumbered property, or property with only slight equity, or when trustee abandons property to secured creditor, there is no actual or constructive disbursement and trustee cannot collect his compensation under 11 USCS § 326)

2 44 B.R. 860 (Bankr. W.D. Ky. 1984).

3 *Id.* at 861 (citing an opinion from the administrative office of the courts).

4 436 B.R. 421 (Bankr. S.D. Tex. 2010).

5 *See, e.g.,* Roeder v. No Respondent, 336 B.R. 470 (Bankr. W.D. Pa. 2007). *In re* Sanders, 155 B.R. 405 (Bankr. W.D. Tex. 1993), *rev'd on other grounds*, 96 F.3D 1444 (5th Cir. 1996).