How City Finances Can Be Restructured: Learning from Both Bankruptcy and Contract Impairment Cases

by

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I. INTRODUCTION

Detroit, Michigan is the largest city to file a chapter 9 bankruptcy case to date, but there are many other municipalities with the same fundamental problem—a combination of massive labor, pension, and bond obligations that render them insolvent. This article discusses the state and federal law available to help these cities return to solvency.

Since World War II, U.S. cities have promised to pay employees billions of dollars in the future for supplying labor in the present.[1] In 2010, the gap between states' assets and their obligations for public sector retirement benefits was $1.38 trillion, up nearly 9% from fiscal year 2009. Of that figure, $757 billion was for pension promises and $627 billion was for retiree health care.[2] Instead of funding these promises with tax revenue as the obligations

[1] *The Widening Gap Update*, THE PEW CHARITABLE TRUSTS, 1 (June 2012) *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Pensions_Update.pdf (last visited Dec. 18, 2013) [hereinafter, the *Pew Widening Gap Update*]; *see also The Trillion Dollar Gap: Unfunded State Retirement Systems and the Roads to Reform*, THE PEW CHARITABLE TRUSTS 17 (Feb. 2010) *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2010/Trillion_Dollar_Gap_Underfunded_State_Retirement_Systems_and_the_Roads_to_Reform.pdf (last visited Dec. 18, 2013).

[2] States and municipalities have often promised increased employee benefits while failing to make the contributions necessary to fund these promises. Pew Widening Gap Update, *supra* note 2, at 1. These figures represent the liabilities of state, and local governments participating in state-wide, retirement systems. Another study focused solely on municipal employee benefit funding found that:

> 61 key cities across America—the most populous one in each state plus all others with more than 500,000 people—emerged [from the Great Recession] with a gap of more than $217 billion between what they had promised their workers in pensions and retiree health care and what they had saved to pay that bill.

A Widening Gap in the Cities, THE PEW CHARITABLE TRUSTS 2 (Jan. 2013) *available at*

accrued, many cities borrowed from the capital markets to fund them. Total outstanding municipal bond debt in the United States for all purposes, including pensions, has grown from less than $20 billion in 1945 to over $3.7 trillion today.[3]

Layered on top of this substantial debt to providers of capital and labor, the near collapse of the financial system in 2008, and the slow pace of recovery since then, has placed enormous strains on the budgets of many municipal governments.[4] While tax revenues have stabilized somewhat from the Great Recession, in most cases they have not returned to previous levels.[5]

Many cities have addressed these challenges by reducing services, cutting payroll, and deferring maintenance to try to balance their budgets.[6] Nearly every state has reduced public pension benefits or increased employee contributions in the last four years.[7] Public employees depend on these wages and benefits. Bondholders expect a city to pay back what it has borrowed. But there are limits to a city's ability to cut services and raise taxes. If a city cuts services too much, or if citizens are taxed beyond their capacity, city residents who are able to pay taxes will have an incentive to move to lower tax, higher service suburbs, triggering a depopulating "death spiral" in that city.

The law offers cities two sources of power to overcome municipal insolvency. First, state "police power" permits a municipality to alter existing contract rights if doing so serves a public purpose and stops short of unconstitutionally impairing those rights. Second, chapter 9 of the Bankruptcy Code[8] gives a municipality the power to reject contracts and to fundamentally restructure its obligations to labor and capital suppliers.

Financial restructuring conducted outside of bankruptcy often focuses on reducing services and cutting public employees' wages and benefits. However, the exercise of police power to modify labor-related contracts is constrained by constitutional protections against the impairment of contracts[9] and, even if available, is only a partial solution.

Federal municipal bankruptcy law permits an insolvent city to engage in a

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www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_city_pensions_report.pdf (last visited Dec. 18, 2013).

[3]The State of the Municipal Securities Market, www.sec.gov/spotlight/municipalsecurities.shtml (last visited Dec. 18, 2013).

[4]*See, e.g.*, MARK MAURO & CHRISTOPHER W. HOENE, BROOKINGS INSTITUTION, Fiscal Challenges Facing Cities: Implications for Recovery (2009).

[5]Pew Widening Gap Update, *supra* note 2, at 4.

[6]*See, e.g.*, CHRISTOPHER W. HOENE & MICHAEL A. PAGANO, NATIONAL LEAGUE OF CITIES, Research Brief on America's Cities 26 (2011).

[7]Pew Widening Gap Update, *supra* note 2, at 8-9.

[8]11 U.S.C. §§ 901-946. References to "Section" or "§," unless otherwise noted, hereinafter refer to title 11 of the United States Code (the "Bankruptcy Code").

[9]*See, e.g.,* U.S. CONST. art. I, § 10.

more fundamental reorganization of its debts that includes reductions in payment to capital and labor-related creditors. In chapter 9, a city can propose a plan of debt adjustment that pays only what it can reasonably afford to holders of unsecured claims, including both unsecured bond debt[10] and labor contract rejection claims, and then discharge the remainder of those obligations.[11]

Currently, there is an open question about what adjustments a municipal debtor can make to public pension obligations, as many of them are expressed in state statutes and protected by state constitutions. None of the recent large chapter 9 debtors has proposed a plan of debt adjustment that made substantial cuts to all three of the major components of municipal insolvency: (i) current labor costs, (ii) pension obligations, and (iii) bond debt.[12]

On July 18, 2013, Detroit, Michigan filed a chapter 9 case in order to restructure its finances at a time when it had a pension underfunding liability of $3.5 billion[13] and bond debt of $9 billion.[14] Since Detroit's chapter 9 filing, newspapers and other media have discussed the broader ramifications of Detroit's bankruptcy[15] and the financial challenges faced by other major American cities that also have substantial bond debt and pension underfunding.[16] The bankruptcy court, on December 5, 2013, found Detroit eligible to

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[10]This article focuses on the fair and equitable treatment of unsecured claims. A major issue in chapter 9 cases is, and will continue to be, whether bond claims are secured or unsecured. An additional important issue will be valuation of collateral backing a secured bond. Under § 506(a)(1), the secured amount of a claim is limited to the value of the collateral, and the remainder of the claim is unsecured. Issues regarding the nature and extent of the secured status of bond claims will likely be the subject of extensive litigation in future chapter 9 cases.

[11]11 U.S.C. §§ 365 and 944(b).

[12]*See, e.g., In re* City of Stockton, Cal., No. 12-32118 (Bankr. E.D. Cal., filed June 28, 2012), Docket Nos. 1204, 1215 (city rejected retiree health benefits but has not proposed substantial impairment of pension funding obligations); *In re* Jefferson Cnty., Ala., No. 11-05736 (Bankr. N.D. Ala., filed Nov. 9, 2011), Docket Nos. 1977, 2182, 2248 (plan restructured bond debt but no substantial labor or pension issues); *In re* City of Vallejo, Cal., No. 08-26813 (Bankr. E.D. Cal., filed May 23, 2008), Docket Nos. 1045, 1109, 1113 (city rejected collective bargaining agreement but its plan did not propose substantial impairment of pension funding obligations).

[13]Henny Sender, *Detroit Warns That Pension Fund Shortfall Likely To Be Understated*, Fin. Times, July 22, 2013, *available at* www.ft.com/intl/cms/s/0/feee59fe-f21a-11e2-afd8-00144feabdc0.html#axzz2brXXzZb5.

[14]*In re* City of Detroit, Michigan, Case No. 13-53846; (Bankr. E.D. Mich., filed July 18, 2013).

[15]*See, e.g.*, Mary Williams Walsh, *Woes of Detroit Hurt Borrowing by Its Neighbors*, N.Y. Times, August 8, 2013, *available at* dealbook.nytimes.com/2013/08/08/detroit-blocks-other-cities-from-bond-market/; Brian Chappatta, *Detroit's Bankruptcy Doesn't Faze the Municipal Bond Market*, Bloomberg Businessweek Aug. 8, 2013, *available at* www.businessweek.com/articles/2013-08-08/detroits-bankruptcy-doesnt-faze-the-municipal-bond-market; Lindsey Smith, *Will Detroit's Bankruptcy Affect Your Hometown?*, Mich. Radio, Aug. 2, 2103, www.michiganradio.org/post/will-detroit-s-bankruptcy-affect-your-hometown.

[16]*See, e.g.*, Monica Davey & Mary Williams Walsh, *Chicago Sees Pension Crisis Drawing Near*, N.Y. Times, Aug. 5, 2013, *available at* www.nytimes.com/2013/08/06/us/chicago-sees-pension-crisis-drawing-near.html?pagewanted=all&_r=0; Bill King, *Pension Plan Funding Key to Houston's Health*, Houston Chron., July 31, 2013, *available at* www.chron.com/opinion/king/article/King-Pension-plan-funding-key-

pursue chapter 9 relief and acknowledged that pension-related claims would be at issue, stating:

> Because under the Michigan Constitution, pension rights are contractual rights, they are subject to impairment in a federal bankruptcy proceeding. . . .
>
> Nevertheless, the Court is compelled to comment. No one should interpret this holding that pension rights are subject to impairment in this bankruptcy case to mean that the Court will necessarily confirm any plan of adjustment that impairs pensions. The Court emphasizes that it will not lightly or casually exercise the power under federal bankruptcy law to impair pensions. . . . [The requirements of the Bankruptcy Code] demand this Court's judicious legal and equitable consideration of the interests of the City and *all of its creditors*, as well as the laws of the State of Michigan.[17]

Thus, Detroit could be the first case to illustrate how "all of its creditors," including current labor, retired labor, and capital claims, can be placed back into balance with a city's ability to generate revenue to meet its ongoing obligations.[18]

This article describes what a city can accomplish in a comprehensive chapter 9 plan that requires all creditors and taxpayers to make a reasonable contribution to the financial restructuring, and analyzes the hurdles to obtaining confirmation of that plan. It also describes two ways of approaching pension liability. The first is through a city filing a chapter 9 plan that restructures only the city's obligation to make pension funding contributions to the separate pension funds that actually pay retirement benefits. The second is through a city filing a chapter 9 plan that is premised on the passage of legislation that changes both the city's pension funding obligations and the benefit payment obligations owed by the separate pension funds.

The state's use of police power to modify existing pension contract rights through an amended pension statute will trigger an inquiry as to whether the

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to-Houston-s-health-4698709.php; Mike Morris, *Council Trying to Gain Measure of Pension Liability*, Houston Chron., Aug. 6, 2013, *available at* www.houstonchronicle.com/news/houston-texas/houston/article/Council-trying-to-gain-measure-of-pension-4712409.php; *see also Chicagoans' Long-Term Debt and Pension Obligations Per Capita Rose 185% Since 2002*, The Civic Federation, (Feb. 27, 2013), www.civicfed.org/civic-federation/blog/chicagoans-local-long-term-obligations-capita-levels-nearly-triple-ten-years.

[17]*In re City of Detroit*, *supra* note 15, "Opinion Regarding Eligibility," Docket No. 1945, at 80 (emphasis added). The eligibility ruling has been appealed.

[18]This article does not examine the details of the Michigan pension statute and Michigan pension claims. Rather, it uses Illinois and Texas as examples to illustrate the details of pension obligations and the strategies available to restructure them.

proposed legislation will unconstitutionally impair contract rights. This article surveys the jurisprudence that has developed, beginning with U.S. Supreme Court cases arising out of the Great Depression, establishing the limits on the use of this police power.

Cities in the vanguard of dealing with modern municipal insolvency have used state police power to try to deal with their financial problems. Court decisions in these cases show the limits of what can and cannot be accomplished outside of a chapter 9 case. They also offer guidance about how to formulate a fair and equitable chapter 9 plan for a city that has, not just bond claims like the municipalities in Depression-era bankruptcies, but also substantial labor and pension obligations.

The possibility of confirming the kind of comprehensive plan suggested by contract impairment cases, coupled with chapter 9 principles of fairness and equity, give municipalities substantial power to resolve their labor, pension, and capital debts, and achieve a feasible and sustainable solution to their insolvency.

II. WHAT CAN A MUNICIPALITY DO IN A CHAPTER 9 CASE?

Chapter 9 of the Bankruptcy Code permits an insolvent[19] municipality[20] to use the powers of federal bankruptcy law to restructure its financial affairs.[21] In states where municipalities are authorized by state statute to file a chapter 9 case,[22] a municipal debtor can, pursuant to § 365 of the Bank-

[19]In the chapter 9 context, "insolvent" means that a municipality is "generally not paying its debts as they become due . . . ; or [is] unable to pay its debts as they come due." 11 U.S.C. § 101(32)(C). This is *not* the asset versus liability "balance sheet" insolvency test used in §§ 101(32)(A), 547 and 548 of the Bankruptcy Code. *See In re* Hamilton Creek Metro. Dist., 143 F.3d 1381 (10th Cir. 1998); *In re* City of Bridgeport, 129 B.R. 332 (Bankr. D. Conn. 1991).

[20]The Bankruptcy Code defines a "municipality" as a "political subdivision or public agency or instrumentality of a state." 11 U.S.C. § 101(40). This definition is quite broad and applies to counties, cities, towns, school districts, municipal utility districts, and many other state entities. COLLIER ON BANKRUPTCY ¶ 900.02[2][a] (Alan N. Resnick et al. eds., 16th ed. rev. 2012).

[21]A debtor is eligible to file a chapter 9 case if it (i) is a municipality, (ii) is specifically authorized under state law to be a chapter 9 debtor, (iii) is insolvent, (iv) desires to effect a plan to adjust its debts, and (v) either (a) has obtained majority approval of creditors in each class for the proposed plan of reorganization, (b) has negotiated in good faith with creditors and failed to obtain such a majority, (c) is unable to negotiate further because such negotiations are impracticable, or (d) reasonably believes a creditor may attempt to obtain a preferential transfer. 11 U.S.C. § 109(c)(1)-(5). Only a municipality is authorized to file a chapter 9 case; involuntary chapter 9 bankruptcy filings are not permitted. 11. U.S.C. § 303. Whether there have been good faith negotiations is subject to a fact-intensive, case by case analysis, as is the issue of whether it is "impracticable" to negotiate further with creditors. It seems clear, however, that if a creditor refuses to participate in negotiations, it has made further negotiations "impracticable." *See, e.g.*, *In re* City of Stockton Cal., 493 B.R. 772, 793-94 (Bankr. E.D. Ca. 2013).

[22]Fifteen states specifically authorize municipal bankruptcy filings. Thirteen states provide for limited or conditional authority. One state, Georgia, prohibits chapter 9 filings. In the remainder, state law is silent or unclear regarding the authority to file municipal bankruptcy. *See, e.g.*, James E. Spiotto, *Historical and Legal Strength of State and Local Government Debt Financing,* NAT'L CONF. OF STATE LEGISLA-

ruptcy Code, reject burdensome executory contracts, including labor contracts. This will, however, result in unsecured rejection damages claims. In a chapter 9 plan, these contract rejection claims can be classified together with other unsecured claims against a city, including unsecured bond claims, in a general unsecured claims class. If the city can prove that its debt adjustment plan is fair and equitable, and meets the other chapter 9 plan confirmation standards, then the holders of unsecured claims can be paid a *pro rata* portion of their debt, and the remainder of the debt can be discharged pursuant to the plan.

The discharge of public pension obligations in bankruptcy is more problematic because, unlike private pensions whose terms are contained in a contract between the parties, the terms of public pension plans are typically set forth in statutes enacted by the state legislature. The pension benefits articulated in state statutes may be found to be "contract rights" protected from modification by state and federal constitutions, but they are not protected from the power of a chapter 9 debtor to breach contracts under federal bankruptcy law.

A. Limitations on the Power of the Bankruptcy Court in a Chapter 9 Case

The bankruptcy court does not have as much power to influence a debtor's conduct in a chapter 9 case as it has in a chapter 11 case.[23] Moreover, the bankruptcy court is not permitted to "interfere with . . . any of the political . . . powers of the debtor; . . . any of the property or revenues of the debtor; or . . . the debtor's use or enjoyment of any income-producing property."[24] These provisions recognize the separation of powers in the United States' federal system and express deference to the political power of a state as delegated to its municipalities.[25]

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tures, 48, (February 2011) http://www.ncsl.org/documents/fiscal/glm11spiotto.pdf (containing a listing of state statutory provisions relating to authorization). For example, Texas law provides that a municipality "may proceed under federal bankruptcy law intended to relieve municipal indebtedness . . . if it has the power to incur indebtedness." Tex. Loc. Gov't Code § 140.001(2007). In contrast, Illinois statutes contain no provision authorizing all municipalities to file a chapter 9 case. *See In re* Slocum Lake Drainage Dist. of Lake Cnty., 336 B.R. 387 (Bankr. N.D. Ill. 2006). In states without clear authority, it would be a question of state law whether a new state statute would be required to give authorization or whether, for example, the governor could do so as the Governor of Michigan did to authorize Detroit's chapter 9 filing. *See* "Authorization to Commence Chapter 9 Bankruptcy Proceeding" attached as Exhibit A to Docket No. 1, *In re* City of Detroit, Michigan, *supra* note 15; *see also In re* New York City Off-Track Betting Corporation, 427 B.R. 256 (Bankr. S.D. N.Y. 2010).

[23]For example, the powers to appoint a trustee, 11 U.S.C. § 1104, or to reduce or increase the debtor's exclusive period to file a plan of debt adjustment, 11 U.S.C. § 1121, are not applicable in a chapter 9 case.

[24]11 U.S.C. § 904(1)-(3).

[25]*See* U.S. v. Bekins, 304 U.S. 27 (1938); *In re* Addison Cmty. Hosp. Auth., 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994) ("A primary distinction between a chapter 11 and a chapter 9 case is that in the latter,

A bankruptcy court does, however, have the power (i) to dismiss a chapter 9 case if it was not filed in good faith or if the petition does not meet the requirements of the Bankruptcy Code;[26] (ii) to deny confirmation of a plan if it finds the plan was not filed in good faith or is otherwise not confirmable;[27] and (iii) to dismiss a case if a plan is not filed or confirmed within a time period set by the court.[28] Under these provisions, a bankruptcy court may compel a chapter 9 debtor to use good faith efforts to file and confirm a plan on a schedule set by the court. If the debtor fails to comply with the requirements of chapter 9, or with the bankruptcy court's orders, the debtor risks having its case dismissed, terminating its access to the benefits available under federal bankruptcy law.

B. Chapter 9 Plan Confirmation Standards

Most chapter 11 plan confirmation standards are applicable in a chapter 9 case,[29] including: (i) the requirement to file a disclosure statement and follow specific rules regarding solicitation of votes for the plan;[30] (ii) the requirement that the plan be proposed "in good faith;"[31] (iii) the requirement that any applicable regulatory approvals be obtained;[32] and (iv) the requirement that the plan be accepted by at least one impaired class of creditors that is not controlled by insiders.[33] However, unlike in chapter 11, only the debtor can file a plan in chapter 9.[34]

There are three central plan confirmation requirements in chapter 9. First, the plan must be in the best interests of creditors. Second, the plan must be feasible. Third, if classes of creditors have not voted unanimously to confirm the plan, the debtor must show that the plan does not discriminate unfairly and that its treatment of creditors in the rejecting classes is fair and equitable.

1. *Best Interests of Creditors and Feasibility*

The Bankruptcy Code provides that a chapter 9 plan can be confirmed if it "is in the best interests of creditors and is feasible."[35]

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the law must be sensitive to the issue of the sovereignty of the states."); *In re* Richmond Unified Sch. Dist., 133 B.R. 221, 225-26 (Bankr. N.D. Cal. 1991).

[26] 11 U.S.C. § 921(c).

[27] 11 U.S.C. §§ 943(b)(1), 901(a) and 1129(a)(3).

[28] 11 U.S.C. §§ 930(a)(3),(4),(5) and 941.

[29] 11 U.S.C. § 901(a).

[30] 11 U.S.C. § 1129(a)(2).

[31] 11 U.S.C. § 1129(a)(3).

[32] 11 U.S.C. § 1129(a)(6).

[33] 11 U.S.C. §§ 1129(a)(8) and (10).

[34] 11 U.S.C. § 941.

[35] 11 U.S.C.§ 943(b)(7).

a. Feasibility

Feasibility in a chapter 9 case has a meaning similar to that used in chapter 11—that the plan is financially sound and likely to be able to be performed—but with an additional component.[36] The debtor must establish that, after all proposed spending cuts, revenue increases and payments to creditors proposed in the plan, the municipality will still be able to serve its citizens at a level it determines to be appropriate in the exercise of its judgment.[37] As the court said in *Mount Carbon*, the "primary purpose of debt restructure for a municipality is not future profit but rather continued provision of public services."[38] Consequently, one of the things the court must take into account in determining feasibility is whether the debtor can "provide future public services at the level necessary to its viability as a municipality."[39] For a chapter 9 plan to be feasible, the debtor must have adequate cash flow to make the payments to creditors set out in the plan and "still have adequate revenues to continue operations because the [municipal] debtor cannot be dismantled or liquidated as in ordinary bankruptcy."[40]

b. Best Interests of Creditors

"[B]est interests of creditors" has a different meaning in chapter 9 than it does in chapter 11. In chapter 11, this test is set forth in § 1129(a)(7)(A)(ii) and focuses on a hypothetical liquidation of the debtor's assets. It requires that each holder of a claim receive under the plan "not less than the amount such holder would so receive . . . if the debtor were liquidated under chapter 7."

This plan confirmation requirement is, however, not included in the list of § 1129(a) subsections that are made applicable in chapter 9.[41] The legislative history of chapter 9 shows that Congress intended this explicit exclusion.

> ". . . The best interests of creditors test does not mean liquidation value as under Chapter XI of the Bankruptcy Act. In making such a determination, it is expected that the court will be guided by standards set forth in *Kelley v. Everglades*

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[36]*See In re* Mount Carbon Metro. Dist., 242 B.R. 18, 34-38 (Bankr. D. Colo. 1999).

[37]*See In re* Corcoran Hosp. Dist., 233 B.R. 449, 453-54 (Bankr. E.D. Cal. 1999) (plan feasible); *In re Mount Carbon Metro. Dist.*, 242 B.R. at 36-38 (plan not feasible).

[38]*Mount Carbon*, 242 B.R. at 34.

[39]*Id.*

[40]COLLIER ON BANKRUPTCY ¶ 943.03[1][f][i][B] (Alan N. Resnick et al. eds., 16th ed. rev. 2010) (citing Newhouse v. Corcoran Irrigation Dist., 114 F.2d 690 (9th Cir. 1940), *cert. denied,* 311 U.S. 717 (1941)).

[41]11 U.S.C. § 901(a).

> *Drainage District*, 319 U.S. 415 (1943) and *Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940) . . . ."[42]

Both of the cases cited in the legislative history assumed that the municipal debtor's assets would not be sold. In *Kelley v. Everglades*,[43] Class I and Class II creditors each had a lien on different property of the municipality. Class I creditors appealed the order confirming the plan, claiming that the plan discriminated unfairly in favor of Class II, placing the relative value of their collateral at issue.[44] The Supreme Court held that the findings supporting confirmation of the plan were inadequate so it vacated the confirmation order and remanded for additional findings.[45]

In setting guidelines for the remand, the court opined that a municipal bankruptcy case was much like a railroad equity receivership case, involving "reorganization of properties that cannot readily be liquidated."[46] It held that where a reorganization plan proposes to pay a secured creditor's claim from future earnings rather than from sale of collateral, the court need not determine the value of the collateral.[47] Rather, the court concluded that it was only necessary to evaluate the future cash flows which were the source of funding for the plan.[48]

In *Fano*,[49] the other case cited in the chapter 9 legislative history concerning the best interests test, an objecting bondholder appealed a plan in which the debtor proposed to reduce by one-third the principal amount of bonds it had issued to build an irrigation system. The Ninth Circuit noted

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[42]Statement of the Hon. Don Edwards, Chairman of the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, upon Introducing the House Amendment to the Senate Amendment to H.R. 8200, 124 *Cong. Rec.* H 11089 (Sept. 28, 1978) (footnotes omitted); Statement by the Hon. Dennis DeConcini, Chairman of the Subcommittee on Improvements in Judicial Machinery of the Senate Committee on the Judiciary, upon Introducing the Senate Amendment to the House Amendment to H.R. 8200, 124 *Congressional Record* S 17406 (Oct. 6, 1978).

[43]Kelley v. Everglades District, 319 U.S. 415, 417-18 (1943) (Class I debt had "a first charge against taxes levied . . . against lands in the District and have a preference over Class II Indebtedness" and Class II debt "was payable from an ad valorem tax of one mill . . . , does not constitute a first charge against any fixed revenue of the District and is not secured by any lien or pledge.").

[44]*Id.*

[45]*Id.* at 422.

[46]*Id.* at 419.

[47] Hence we concluded that findings of the future earnings of the reorganized railroad distributable to each class of security holders and creditors were an adequate substitute for findings of asset value in terms of dollars and cents, which we held could be dispensed with as affording no more than a delusive appearance of a certainty which the subject matter did not warrant.

Id.

[48]*Id.* ("[W]here future tax revenues are the only source to which creditors can look for payment of their claims, considered estimates of those revenues constitute the only available basis for appraising the respective interests of different claims of creditors.").

[49]Fano v. Newport Heights Irrigation Dist., 114 F.2d 563 (9th Cir. 1940).

that the debtor had spent twice what was needed to refurbish its watering equipment and had failed to show why it was unable to use its taxing power to enact the small tax increase that would have permitted it to make its bond payments.[50] The court concluded that, in view of this evidence, the plan was not "'equitable' and 'fair' and for the 'best interests of creditors.'"[51] The court reversed the confirmation of the debtor's plan, finding that it would be "unjust" to permit the municipality to keep its valuable assets and discharge debt when it had not made reasonable efforts to limit expenditures or increase revenue. Thus, the "best interests of creditors" analysis in *Fano* focused, not on the liquidation value of the city's assets, but on whether the debtor had acted reasonably.

A year before its decision in *Kelley v. Everglades*, the Supreme Court made a "best interests of creditors" analysis the centerpiece of its opinion in *Asbury Park*.[52] In that case, bondholders asserted that a reduction in the bond interest rate implemented in a plan remedying a municipal insolvency had impaired their contract rights. The Supreme Court explained that when considering how a municipal restructuring plan can best resolve the claims of unsecured creditors, the focus should be on how "the municipality is to be kept going as a political community and, at the same time, [realize] the utmost for the benefit of the creditors."[53]

The Supreme Court observed that:

> The principal asset of a municipality is its taxing power and that, unlike an asset of a private corporation, cannot be available for distribution. An unsecured municipal security is therefore merely a draft on the good faith of a municipality in exercising its taxing power. The notion that a city has unlimited taxing power is, of course, an illusion. A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power. . . .[54]

The opinion highlighted the distinction between the broader remedies available to creditors with claims against private entities and the much more limited mandamus remedy available to unsecured municipal bondholders who cannot seize the city's assets.

> In effect, therefore, the practical value of an unsecured claim against the city is inseparable from reliance upon the effectiveness of the city's taxing power. The only remedy for the

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[50]*Id.* at 565-66.
[51]*Id.* at 566.
[52]Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942).
[53]*Id.* at 510.
[54]*Id.* at 509.

> enforcement of such a claim is a mandamus to compel the levying of authorized taxes. The experience of the two modern periods of municipal defaults, after the depression of '73 and '93, shows that *the right to enforce claims against the city through mandamus is the empty right to litigate.*[55]

Indeed, *Asbury Park* found that, in light of the poor remedies available to the unsecured bondholders,[56] the debt composition plan had actually made the bonds worth more than when default was looming, and, thus, there was no actual impairment of the bondholders' rights.[57]

Fano, Kelley v. Everglades, and *Asbury Park* confirm that a municipality cannot and should not be liquidated and that a municipal reorganization plan should be premised on what a city's revenues can support.[58] The "best interest of creditors" analysis in those cases expanded the law that had developed during the Great Depression concerning what is "fair and equitable," directing the focus away from what could be recovered by stripping a city of its assets, and toward how much a city could reasonably pay as it continues to operate and serve its citizens.

2. *Cram Down Power—Fair and Equitable Treatment*

Creditors have the opportunity to vote to approve or reject a proposed chapter 9 plan.[59] If one or more of the classes of creditors vote to reject the plan, the plan can still be confirmed if it satisfies the "cram down" provisions of chapter 11 that are made applicable in chapter 9 cases.[60] A plan can be

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[55] *Id.* at 509-10 (emphasis added).

[56] The question whether the remedy on this contract was impaired materially is affected not only by the precarious character of the plaintiff's right, but by considerations of fact—of what the remedy amounted to in practice. . . . To say that the right of the Asbury Park bondholders in 1935 was of precarious character is pure understatement. And we have already seen how empty was the remedy with which to enforce that right.

Id. at 514.

[57] Here we have just the opposite—no security whatever except the effective taxing power of the municipality; the effective taxing power of the municipality prostrate without state intervention to revive the famished finances of the city; state intervention, carefully devised, worked out with scrupulous detail and with due regard to the interests of all the creditors, and scrutinized to that end by the state judiciary with the result that that which was a most depreciated claim of little value has, by the very scheme complained of, been saved and transmuted into substantial value.

Id. at 515-16.

[58] *See also* Newhouse v. Corcoran Irrigation Dist., 113 F.2d 690, 691 (9th Cir. 1940), *cert. denied*, 311 U.S. 717 (1941) (a municipality's assets and property "cannot be disposed of as in the ordinary bankruptcy proceeding . . .").

[59] 11 U.S.C. §§ 901(a) and 1129(a)(8).

[60] 11 U.S.C. § 901(a) making §§ 1129(b)(1), 1129(b)(2)(A) and 1129(b)(2)(B) applicable in a chapter 9 case.

confirmed over the objection of a rejecting class of creditors "if the plan does not discriminate unfairly, and is fair and equitable" to that class.[61] Generally, a plan does not discriminate unfairly if it provides similar treatment to creditors with similar claims.[62]

Chapter 9 explicitly adopts the three alternative mechanisms for providing fair and equitable treatment to secured claims,[63] and incorporates the absolute priority rule for fair and equitable treatment of unsecured claims,[64] that are applicable in chapter 11 cases.

Secured claims are treated fairly and equitably in a chapter 9 case if the plan (i) allows the secured creditor to retain its lien and to receive cash payments over time which have a present value equal to the value of the secured creditor's collateral as of the effective date of the plan; (ii) provides for a sale of the secured creditor's collateral at which the secured creditor can credit bid; or (iii) provides the secured creditor with the "indubitable equivalent of its claim," which includes, among other things, the option of obtaining ownership and possession of the collateral securing its claim.[65]

The Bankruptcy Code provides that unsecured creditors who are not paid in full are treated fairly and equitably under a plan as long as "any claim or interest that is junior . . . will not receive or retain under the plan or on account of such junior claim or [equity] interest any property."[66] This is generally referred to as the "absolute priority rule" and, in corporate chapter 11 cases, it means that shareholders, the most junior class of claims or interests, cannot retain any equity ownership interests unless all holders of allowed unsecured claims are paid in full.[67] Often, when there is not enough value in a corporate chapter 11 case to pay creditors in full, existing corporate stock is cancelled and newly issued shares in the reorganized company are distributed to unsecured creditors under the chapter 11 plan.

Since there are no "equity owners" of a municipality, the literal terms of the absolute priority rule contained in § 1129(b)(2)(B)(ii) can easily be met in a municipal case even if unsecured creditors are not paid in full. One case decided under current chapter 9, *Corcoran Hospital*,[68] applied the absolute

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[61]11 U.S.C. § 1129(b)(1).

[62]*See* Begier v. I.R.S., 496 U.S. 53, 58 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code."); *In re* Combustion Eng'g, Inc., 391 F.3d 190, 239 (3rd Cir. 2004) ("The Bankruptcy Code furthers the policy of 'equality of distribution among creditors' by requiring that a plan of reorganization provide similar treatment to similarly situated creditors"); 11 U.S.C. § 1123(a)(4).

[63]11 U.S.C. § 1129(b)(2)(A).

[64]11 U.S.C. § 1129(b)(2)(B).

[65]11 U.S.C. § 1129(b)(2)(A); *see* RadLAX Gateway Hotel v. Amalgamated Bank, 132 S. Ct. 2065 (2012).

[66]11 U.S.C. § 1129(b)(2)(B)(ii).

[67]*See*, *e.g.*, Case v. L. A. Lumber Prods., 308 U.S. 106 (1939).

[68]*In re* Corcoran Hosp. Dist., 233 B.R. 449,458 (Bankr. E.D. Cal. 1999).

priority rule by its literal terms. It relied on bankruptcy cases of not-for-profit organizations in reaching its conclusion that it was permissible for a municipal debtor to "continue in existence and in possession of its property even though . . . unsecured creditors will not be paid in full."[69] It held that "control [of the debtor's assets] alone, divorced from any right to share in corporate profits or assets, does not amount to an equity interest."[70] However, the *Corcoran Hospital* analysis did not end there. The court went on to apply what it called a "good faith" standard under § 1129(a)(3)[71] citing to two Great Depression era cases that had analyzed whether a plan was fair and equitable by considering whether spending had been reasonably limited or taxes reasonably increased.[72]

Cases analyzing whether a plan is "fair and equitable" have focused on a wide range of facts and theories.[73] A salient consideration has been whether a chapter 9 plan proposes to pay unsecured creditors "all that they 'can reasonably expect in the circumstances.'"[74] Applying this standard, some courts have denied confirmation when the debtor did not sufficiently cut expenditures or did not make adequate use of taxation.[75] Other courts have determined that a plan is fair and equitable if it provides creditors with "the maximum . . . [the municipality] could reasonably pay."[76]

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[69]*Id.* at 458.

[70]*Id.* ("The mere fact that . . . [citizens] are benefited by . . . [the municipality's] operations and might be disadvantaged by its demise also does not give them an 'interest cognizable in bankruptcy.'" "[T]he present group retaining control over the debtor entity does not give them anything . . . Certainly not a favored position over the dissenting creditor. It gives them problems and great anguish ahead.").

[71]*Id.* at 459

[72]*Id.* at 460-61 (citing *Fano,* 114 F.2d at 565-66 and Newhouse v. Corcoran Irrigation Dist., 114 F.2d 690, 691 (9th Cir. 1940)).

[73]For example, under old chapter IX, the fair and equitable standard was held also to include a feasibility requirement. Kelley v. Everglades Drainage Dist., 319 U.S. 415 (1943). Fair and equitable has been held to mean that the plan must embody a "fair and equitable bargain openly arrived at and devoid of overreaching." Town of Belleair, Fla. v. Groves, 132 F.2d 542, 542 (5th Cir. 1942), *cert. denied*, 318 U.S. 769 (1943). Fair and equitable has also been interpreted as requiring that there is no unfair discrimination in favor of any creditor or class of creditors. Am. United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 147 (1940).

[74]Lorber v. Vista Irrigation Dist., 127 F.2d 628, 639 (9th Cir. 1942); COLLIER ON BANKRUPTCY § 943.03 [1][f][i][B] (Alan N. Resnick et al. eds., 16th ed. rev. 2010).

[75]*See, e.g.,* Fano v. Newport Heights Irrigation Dist., 114 F.2d at 565-66 (Confirmation denied where the debtor had spent twice what was needed on capital expenditures to improve facilities that had been in bad repair and, even with that, would only have had to raise taxes a small amount to meet existing bond obligations). However, taxes need not be increased where there is evidence that this would not be feasible. *In re Corcoran Hosp. Dist.*, 233 B.R. at 461 (Bankr. E.D. Cal. 1999) ("[I]n these cases under Chapter IX, the Ninth Circuit Court of Appeals looked at the insolvency of the debtor and whether the debtor could, in fact, raise taxes sufficient to pay the bondholders in full.").

[76] [H]eavy delinquencies in meeting assessments . . . an increase of taxes and assessments would make this matter worse . . . the need for large expenditures in the restoration to good working conditions of the District irrigation pipelines . . . the District bonds were listed on exchange at 18 cents; while RFC offered to refinance

The analysis of whether "[creditors] are receiving all that they can reasonably expect" and whether the city is paying "the most . . . it could reasonably pay" has included the following inquiries: (i) Has the municipality acted reasonably in reducing the scope and cost of the services it provides?; (ii) Has the municipality taxed its residents in a reasonable and adequate fashion?;[77] and (iii) Does the municipality have adequate funds to carry out its chapter 9 plan? The statute suggests, and courts have held, that a chapter 9 debtor's business judgment on these issues is entitled to deference.[78]

The Great Depression era municipal cases that developed the "all it can reasonably pay" standard dealt predominantly with the reasonableness of the amount of bond debt being discharged, rather than with labor contract rejection claims and related pension liabilities. However, the principles they developed can be used to analyze the fair and equitable treatment of any unsecured claim, including labor-related claims. Today, labor-related claims typically represent a substantial portion of a municipality's financial obligations. Therefore, we turn next to a discussion of the chapter 9 mechanisms for adjusting labor related liabilities.

C. Rejection of Labor Contracts

In *N.L.R.B. v. Bildisco & Bildisco*,[79] the Supreme Court set the standard for a debtor's rejection of labor contracts in a bankruptcy case under § 365.[80] *Bildisco* held that collective bargaining agreements are executory contracts that can be rejected if the debtor establishes it made reasonable efforts to negotiate a voluntary modification, those efforts did not produce a prompt and satisfactory solution, the terms of the agreement are burdensome, and the

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> at 55¢ . . . substantial evidence that the District had been unsuccessful in obtaining a loan from sources other than RFC. We hold that the findings are a sufficient basis for the concluding paragraph IX to the effect that 55¢ on the dollar was the maximum that the District could reasonably pay on outstanding bonds.

Lorber v. Vista Irrigation Dist. 143 F.2d 282, 284 (9th Cir. 1942), *cert. denied*, 323 U.S. 784 (1944).

[77]The use of the power of taxation is within the discretion of the municipality. The U.S. Supreme Court has stated:

> The principal asset of a municipality is its taxing power and that, unlike an asset of a private corporation, cannot be available for distribution. An unsecured municipal security is therefore merely a draft on the good faith of a municipality in exercising its taxing power. The notion that a city has unlimited taxing power is, of course, an illusion. A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power.

Asbury Park, 316 U.S. at 509.

[78]*See* 11 U.S.C. § 904; *see also In re Corcoran Hosp. Dist.*, 233 B.R. at 459-61; *In re* Sanitary & Improvement Dist. No. 7, 98 B.R. 966 (Bankr. D. Neb. 1989).

[79]N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513 (1984).

[80]*See, e.g., In re* City of Vallejo, 432 B.R. 262, 270 (E.D. Cal. 2010); *In re City of Vallejo*, 403 B.R. 72, 77 (Bankr. E.D. Cal 2009); *In re* County of Orange, 179 B.R. 177, 183 (Bankr. C.D. Cal. 1995).

equities favor rejection of the contract.[81]

A chapter 9 debtor's rejection of a labor contract is a permanent, anticipatory breach of that contract[82] which gives rise to an unsecured rejection damages claim against the municipality. The allowed amount of such a claim is the present value of the damages from the breach.[83] In chapter 9, a municipality may pay these unsecured claims less than the full amount due and discharge the remainder of the claim.[84]

After the *Bildisco* decision, Congress added §§ 1113 and 1114 to the Bankruptcy Code to impose a more stringent standard for rejection of labor contracts by chapter 11 debtors. These sections are not applicable in chapter 9 and, thus, a municipality in bankruptcy is held only to the *Bildisco* standard. This gives municipal debtors more flexibility in dealing with collective bargaining agreements than chapter 11 debtors have.[85]

Since Bankruptcy Code § 365 preempts state law, a municipality that obtains chapter 9 relief is exempt from compliance with otherwise applicable state labor laws.[86] As one bankruptcy court explained:

> When a state authorizes its municipalities to file a chapter 9 petition, it declares that the benefits of chapter 9 are more important than state control over its municipalities. Consequently, if a municipality is authorized by the state to file a chapter 9 petition, it is entitled to fully utilize 11 U.S.C. § 365 to accept or reject its executory contracts.[87]

In *City of Stockton*,[88] shortly after the case was filed, retired employees sought an injunction to prohibit the city from unilaterally changing retiree medical benefits before the city had moved to reject the collective bargaining agreement that provided for those benefits. The retirees accused the city of

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[81] *N.L.R.B.*, 465 U.S. at 526.

[82] 11 U.S.C. § 365(g).

[83] 11 U.S.C. § 365(g)(1).

[84] 11 U.S.C. § 944(b).

[85] Although the Bankruptcy Code has been amended more than once since the passage of § 1113 and § 1114, Congress has chosen not to make those sections applicable in a chapter 9 case.

[86] *In re City of Vallejo*, 432 B.R. at 268-69; *see also* Kroske v. U.S. Bank Corp., 432 F.3d 976, 984-85 (9th Cir. 2005).

[87] Any attempt to limit a debtor's rights under § 365 through recourse to state sovereignty must also be weighed against the filing requirements unique to Chapter 9. . . . Since the state must consent to a bankruptcy filing under § 109(c)(2), the state consents to the displacement of its own law in order to obtain the benefits uniquely available under the Bankruptcy Code.

In re City of Vallejo, 403 B.R. 72, 76 (E.D. Cal. 2009) (quoting Ryan Preston Dahl, *Collective Bargaining Agreements and Chapter 9 Bankruptcy*, 81 AM. BANKR. L. J. 296, 333 (2007)).

[88] Ass'n of Retired Emps. of the City of Stockton v. City of Stockton, Cal. *(In re* City of Stockton), 478 B.R. 8 (Bankr. E.D. Cal. 2012).

unilaterally impairing their contract rights in violation of California law and U.S. Constitutional provisions prohibiting a state from impairing contracts.[89]

The bankruptcy court denied the injunction holding that §§ 903 and 904 of the Bankruptcy Code prohibited it from controlling the state's exercise, through the city, "of . . . political or governmental powers, including expenditures" and from "interfer[ing] with any of the property or revenues of the debtor."[90] The court noted that the Bankruptcy Clause[91] "necessarily authorizes Congress to make laws that would impair contracts,"[92] indeed, the "purpose of all bankruptcy legislation is to interfere with the relations between parties concerned – to change, modify, or impair the obligations of their contracts."[93] The court further observed that:

> The goal of the Bankruptcy Code is adjusting the debtor—creditor relationship. Every discharge impairs contracts. While bankruptcy law endeavors to provide a system of orderly, predictable rules for treatment of parties whose contracts are impaired, that does not change the starring role of contract impairment in bankruptcy.[94]

According to *City of Stockton*, states "have not reserved the power of bankrupt laws, and are expressly prohibited from passing laws impairing the obligations of contracts . . . [w]hile a state cannot make a law impairing the obligation of contract, Congress can do so."[95]

City of Stockton observed that § 365 gives a chapter 9 debtor the power to reject collective bargaining agreements and to treat monetary damages resulting from that rejection as an unsecured claim in its chapter 9 plan of debt adjustment.[96] Moreover, as construed by the Supreme Court in *Bildisco*, § 365 gives a debtor the power to breach such contracts prior to a formal rejection.[97] Indeed, the Supreme Court held in *Bildisco* that:

> . . . [plaintiff] is precluded from, in effect, enforcing the terms of the collective-bargaining agreement . . . the practical effect of the . . . [requested relief] would be to require adherence to the terms of the collective-bargaining agreement. But the *filing of the petition in bankruptcy means that the collective-*

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[89]*Id.* at 14.
[90]*Id.* at 16-21.
[91]U.S. CONST. art I, § 8, cl. 4 (the "Bankruptcy Clause").
[92]*In re City of Stockton*, 478 B.R. at 15 (citing Sturges v. Crowninshield, 17 U.S. 122, 191 (1819)).
[93]*Id.* (citing Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513, 530 (1936)).
[94]*Id.* at 16.
[95]*Id.* at 15-16 (citing Sturges v. Crowninshield, 17 U.S. 122, 191 (1819)).
[96]*Id.* at 24-26.
[97]*Id.*

> *bargaining agreement is no longer immediately enforceable, and may never be enforceable again.* Consequently, . . . enforcement of a claimed violation of . . . [the agreement] would run directly counter to the express provisions of the Bankruptcy Code and to the Code's overall effort to give a debtor-in-possession some flexibility and breathing space. . . . We conclude that from the filing of a petition in bankruptcy until formal acceptance, the collective-bargaining agreement is not an enforceable contract . . . .[98]

D. Modifying Pension Benefits—Special Issues Presented by Constitutionally Protected State Statutory Contract Rights.

The discharge of public pension obligations in bankruptcy is more complex than the rejection of labor contracts for several reasons. First, a municipality's pension funding obligations and the terms of public employees' pension benefits are typically set forth in state statutes.[99] Second, many state constitutions accord public pension benefits status as constitutionally protected "contract rights." Third, if the unpaid portion of any claim for the rejection of pension-related "contract rights" is discharged pursuant to a chapter 9 plan, the statute defining the municipality's pension obligations under state law would still exist after the chapter 9 plan is consummated. Finally, if a state legislature were to amend a pension statute to reduce both pension benefits and funding obligations, this use of state "police power" would be subject to scrutiny as a possible violation of state and federal constitutional prohibitions against the impairment of contracts. To work through these issues, it is helpful to start by understanding the history and structure of municipal pensions.

1. *Statutory Pension Rights and the Obligation to Fund Pensions.*

Historically, in many states a public employee's right to receive pension benefits under state statutes was construed as a gratuity that could be changed or eliminated at will by the legislature.[100] In response to the harsh

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[98] *Bildisco*, 465 U.S. at 531 (emphasis added).

[99] *See, e.g.*, Illinois Pension Code: 40 Ill. Comp. Stat. 5/8-101 *et seq.* (1963) and Texas Pension Code: Tex. Gov't Code, 810.001(a)(2) (2005).

[100] > [T]he right of a pensioner to receive monthly payments from the pension fund after retirement from service, or after his right to participate in the fund has accrued, is predicated upon the anticipated continuance of existing laws, and is subordinate to the right of the Legislature to abolish the pension system, or diminish the accrued benefits of pensioners thereunder . . . .

Dallas v. Trammell, 101 S.W.2d 1009, 1013 (Tex. 1937); *see also* Reames v. Police Officers' Pension Bd. of the City of Hous., 928 S.W.2d 628, 632 (Tex. App.-Houston [14th Dist.] 1996, no writ) (noting that a

results caused by this lack of protection, many states enacted statutory or constitutional provisions intended to enhance the protection of pension benefits. For example, the revised state constitution drafted by the 1970 Illinois Constitutional Convention and later ratified by Illinois voters[101] included a provision declaring that membership in a public pension in Illinois is an enforceable contractual relationship whose benefits are not subject to being diminished or impaired.[102] As eventually enacted, however, the Illinois Constitution protects pensions as contractual rights, but does not "require the funding of any pensions" or create a property right in favor of pension beneficiaries.[103] The Illinois Supreme Court has consistently held that although the Illinois Pension Clause strengthens pension rights, it does not control the separate issue of how pension benefits are funded.[104]

Similarly, in 2003, the Texas Constitution was amended to provide that, with respect to non-statewide public retirement systems, accrued and vested retirement benefits cannot be reduced or otherwise impaired.[105] Moreover, the amendment, for the first time, made the municipality "jointly responsible" with the pension fund for ensuring that protected benefits are not reduced or otherwise impaired.[106]

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pensioner in a statutory pension plan does not have a vested right to his pension; he merely has an expectancy based upon anticipated continuance of existing law.); *Ex parte Abell*, 613 S.W.2d 255, 261-62 (Tex. 1981) (same). People ex rel. Sklodowski v. State of Ill., 182 Ill. 2d 220, 228, 695 N.E.2d 374, 377 (1998) (citing Bergin v. Bd. of Trs. of the Teachers' Retirement Sys., 31 Ill. 2d 566, 574, 202 N.E.2d 489, 494 (1964)); Arnold v. Bd. of Trs. of Cnty. Emps. Annuity and Benefit Fund of Cook Cnty., 84 Ill. 2d 57, 62, 417 N.E.2d 1026, 1028 (1981).

[101]*See* Eric M. Madiar, *Is Welching On Public Pension Promises an Option For Illinois? An Analysis of Article XIII, Section 5 of the Illinois Constitution* [hereinafter Madiar] 17, n. 146, *available at* http://www.senatedem.ilga.gov/index.php/component/content/article/108-public-information-brochures/1517-pension-debate (last visited Dec. 18, 2013).

[102]"Membership in any pension retirement system of the State, any unit of local government or school district, or agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." ILL CONST., Art. XIII, Sec. 6

[103]Madiar, *supra* note 101, at 19.

[104]"The transcripts from the Conventions make clear that the purpose of the amendment was to clarify and strengthen the right of the state and municipal employees to receive their pension benefits, but not to control funding." McNamee v. State of Ill., 672 N.E. 2d 1159, 1162-63 (Ill. 1996); *see* People ex rel. Sklodowski v. State of Ill., 695 N.E. 2d at 378.

[105] (d) . . . a change in service or disability retirement benefits or death benefits of a retirement system may not reduce or otherwise impair benefits *accrued* . . .

(e) Benefits *granted* to a retiree or other annuitant before the effective date of this section and in effect on that date may not be reduced or otherwise impaired.

(f) The political subdivision or subdivisions and the retirement system that finance benefits under the retirement system are jointly responsible for ensuring that benefits under this section are not reduced or otherwise impaired.

TEX. CONST. Art. XVI, § 66(d)-(f) (emphasis added).

[106]However, the amendment provided that political subdivisions would be exempt from application of this section if the political subdivision held an election and a majority of the voters elected to opt-out of the amendment. *See* TEX. CONST. Art. XVI, § 66(h). Certain Texas cities did vote to opt out. For

Generally, state statutes create or authorize "pension funds" or "pension systems" as separate legal entities that (i) receive funding from cities and employees and (ii) pay pension benefits to municipal employees. This is the case in both Texas[107] and Illinois.[108] This separate pension "fund" or "system" receives contributions from the municipality and participating employees on terms set forth in the enabling state statute.[109] State laws vary on whether a municipality has an obligation to ensure the payment of pension benefits under a pension statute beyond making its statutorily required pension funding contribution.[110] However, it is the pension fund, not the municipality, which is obligated to make the pension benefit payments to beneficiaries as determined by the calculations set forth in the applicable pension statutes.[111]

The pension issue directly relevant in a chapter 9 case is what the *municipality* can do to modify and partially discharge its statutory obligation to make contributions to the pension fund. Whether the *pension fund* can meets its statutory "contract" obligation to pay pensions is not necessarily at issue in a *municipality's* bankruptcy.

2. *Different Approaches to Modifying Pension Benefits*

A municipality that is eligible to be a chapter 9 debtor and seeks to modify its pension funding obligations in bankruptcy is faced with a choice. One option is to attempt to resolve its pension funding issues solely under federal bankruptcy law where there is little precedent directly on point. Alternatively, it can ask the state legislature to modify pension benefit and funding obligations. If it chooses the latter approach, its request will be considered in the context of a substantial body of case law that has developed over the last seventy five years regarding when a state's modification of contract rights is constitutionally permissible.

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example, voters in Houston, Texas approved Proposition 1 electing to opt out of the application of the amendment. Dan Feldstein, *Voters Approve Proposition 1*, HOUSTON CHRON., May 15, 2004, *available at* http://www.chron.com/news/houston-texas/article/Voters-approve-Proposition-1-1578668.php.

[107] *E.g.*, TEX. REV. CIV. STAT. art. 6243h (Vernon's 2001).

[108] Any annuity and benefit fund, annuity and retirement fund or retirement system, heretofore or hereafter created by the legislature of the State of Illinois for the benefit of employees of the State or of any county, city, town, municipal corporation or body politic and corporate, located in the State of Illinois and functioning pursuant to legislative enactment . . . is hereby declared to be a pension fund and to be a body politic and corporate under the title specified in the law creating such fund, . . .

40 ILL. COMP. STAT. 5/22-401 (1963).

[109] *See, e.g.*, TEX. REV. CIV. STAT. art. 6243h § 8(d) (Vernon's 2001); 40 ILL. COMP. STAT. 5/8-173(a) (1963).

[110] *See, e.g.*, TEX. CONST. Art. XVI, § 66(f); 40 ILL. COMP. STAT. 5/22-404 (1963).

[111] *See, e.g.*, TEX. REV. CIV. STAT. art. 6243h § 10 (Vernon's 2001); 40 ILL. COMP. STAT. 5/22-403 (1963).

In a state where the right to file a chapter 9 case is unavailable or ambiguous, a city may (i) seek to resolve its pension issues by negotiating with its pension funds and pension beneficiaries, (ii) try to change state law relating to pension funding and benefit obligations, and/or (iii) obtain authorization to file a chapter 9 case.

a. A Purely Federal Chapter 9 Approach

The *City of Stockton* case clearly establishes the power of a city to unilaterally breach, then later reject, contracts concerning retiree healthcare benefits in a chapter 9 case. However, that case deals with rights under a collective bargaining agreement, the type of contract the U.S. Supreme Court plainly held could be rejected in *Bildisco*,[112] not a pension "contract" expressed in a state statute.

A chapter 9 debtor could argue that the federal government has the power under the Bankruptcy Clause to enact bankruptcy laws whose purpose is to impair contract rights[113] and these "statutory contract rights" merit no more deference than private contract rights that are subject to (i) rejection under § 365, (ii) claims allowance under § 502, and (iii) discharge under both §§ 1129(b) and 944(b).

A chapter 9 debtor could further argue that, even though the state statute requiring pension funding would still exist post-confirmation, a municipality's monetary obligation to comply with that statute is merely another claim that can be calculated in a chapter 9 case, whether as part of a § 365 rejection damage claim or otherwise under § 502, and paid pursuant to a chapter 9 plan. Section 502 establishes a detailed procedure for filing, contesting, and allowing claims. "Claim[s]" are broadly defined in the Bankruptcy Code to include any "right to payment, whether or not such right is . . . unliquidated, . . . contingent, . . . [or] unmatured . . ."[114] A right to payment is a claim regardless of whether the debtor's obligation is contingent or not yet matured,[115] and the filing of a bankruptcy petition accelerates claims otherwise due in the future.[116]

A debtor's breach of a statutory obligation has been held to be a claim

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[112]N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513 (1984).

[113]*See, e.g.*, discussion of *In re City of Stockton, Cal.*, *supra*.

[114]11 U.S.C. § 101(5).

[115]*See* COLLIER ON BANKRUPTCY ¶ 101.05[1] (Alan N. Resnick et al. eds., 16th ed. rev. 2011); *see also In re* Oxford Mgmt., 4 F.3d 1329 (5th Cir. 1995) (commissions owed by debtor on rents to be collected in the future were claims); *In re* Rosteck, 889 F.2d 694 (7th Cir. 1990) (prepetition contract obligation for future condominium assessments was a claim). *See* JELD WEN, Inc. v. Van Brunt *(In re* Grossman's Inc.), 607 F.3d 114, 122-27 (3rd Cir. 2010) (a tort claim arises when the creditor is exposed to a debtor's harmful product, even if the injury does not manifest itself until after the bankruptcy); Lemelle v. Universal Mfg. Corp., 18 F.3d 1268, 1273-77(5th Cir. 1994) (same).

[116]*See, e.g.*, U.S. Bank Trust N.A. v. Am. Airlines, Inc. *(In re* AMR Corp.), 485 B.R. 279, 292-93 (Bankr. S.D.N.Y. 2013).

subject to discharge in a bankruptcy case. In *FCC v. NextWave Personal Communications, Inc.*,[117] the Supreme Court rejected the Federal Communications Commission's argument that the continued installment payments owed by the debtor for purchase of a broadcast frequency license did not constitute a claim subject to discharge in bankruptcy because the ongoing payments were a regulatory condition to maintaining the license.

Environmental cases have reached similar conclusions, holding that a statutory obligation to remove hazardous wastes can be reduced to a claim and discharged in bankruptcy.[118] For example, in *In re Crystal Oil Company*,[119] the debtor filed a chapter 11 case, a claims bar date was set, and a plan of reorganization was confirmed. Years after plan confirmation, the Louisiana Department of Environmental Quality asserted that Crystal Oil was required to pay over $20 million to fund the clean-up of hazardous waste at a former refinery site. The Fifth Circuit held that because the department had known about the environmental liability claim prior to the bar date and had filed no proof of claim, its claim against Crystal Oil for environmental remediation had been discharged, even though, after plan consummation, there was a statute in place requiring that the site be cleaned up and, based on that statute, Crystal Oil would owe millions of dollars for the remediation of the site that the state was about to undertake.[120]

There is no case law directly addressing whether labor-related statutory obligations may be reduced to claims subject to discharge in bankruptcy. However, based on the broad interpretation of what constitutes a "claim" in bankruptcy, even though a state pension statute would still exist after consummation of the chapter 9 plan, the former municipal debtor should have no obligation to pay more than was proposed in the confirmed plan. If the plan was confirmed, that would be evidence that the city's pension obligations had been calculated and allowed under § 502, treated fairly and equitably, and discharged pursuant to a chapter 9 plan under §§ 1129, 944, and 524. To seek to collect a discharged claim post-confirmation would be a violation of the discharge injunction, and punishable by sanctions.[121]

This, however, is not a complete solution to pension issues. A chapter 9 discharge of a debtor city's pension funding obligations would not alter a non-debtor pension fund's benefit payment obligations under the applicable pension statute. It would merely reduce the funding it receives from the debtor

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[117]FCC v. NextWave Personal Commc'ns, Inc., 537 U.S. 293, 302-04 (2003).

[118]*See* Ohio v. Kovacs, 464 U.S. 279, 282 (1985); *see also In re* Chateaugay, 944 F.2d 997, 1001 (2d Cir. 1991).

[119]*In re* Crystal Oil, 158 F.3d 291, 296-98 (5th Cir. 1998).

[120]*Id.* at 295; *Cf.* Bos. and Me. Corp. v. Mass. Bay Transp. Auth., 587 F.3d 89 (1st Cir. 2009).

[121]Section 944 provides for the discharge of debt in a chapter 9 plan and § 524 enjoins creditor action to collect a discharged debt.

municipality. Discharging a municipality's statutory pension funding obligation could render its related pension funds insolvent if the benefits the pension funds are obligated to pay remain unchanged. This would merely shift the insolvency to another entity that might then default on the payment of the "constitutionally protected, statutory contract rights" of retirees.

The situation facing the Northern Mariana Islands Retirement Fund (the "Fund") illustrates this dynamic. The pension fund for government employees of the Northern Mariana Islands, a U.S. Commonwealth, filed bankruptcy asserting that it was only 32% funded, that it would deplete its assets by July 2014, and thereafter be "unable to provide any level of benefits to current and future Beneficiaries."[122] The court found that the Fund was not eligible to be a debtor and dismissed the case but stated:

> the trustees of the Fund should be praised, not criticized, for commencing this case. The trustees find themselves in an intolerable position. The Fund for which they are responsible is caught between an irresistible force—obligations to retirees which it cannot pay—and an immovable object—the government, which has persistently failed to pay its debt to the Fund.[123]

Having no access to relief under the Bankruptcy Code, the Fund reached a settlement in a pending class action suit brought by pension beneficiaries pursuant to which the assets of the Fund were transferred to a settlement fund under the control of the court from which beneficiaries would receive reduced benefits.[124] As a condition to the settlement, and with the consent of the Fund, the court appointed a "'Trustee,' possessing all the powers of a federal equity receiver, 'to administer and run [the Fund] . . .'"[125] It thus addressed the Fund's insolvency with an old form of financial restructuring, negotiation implemented through a receivership.[126] Indeed, many important bankruptcy reorganization concepts originated in federal equity receiver-

[122]Declaration Of Richard S. Villagomez In Support Of First Day Pleadings, p. 4-5, *In re* N. Mar. I. Ret. Fund, No. 1:12-bk-00003 (D. N. Mar. I. Apr. 17, 2012), ECF No. 8.

[123]*In re* N. Mar. I. Ret. Fund, No. 12-00003. 2012 U.S. Dist. LEXIS 131709, at *8 (2012).

[124]Final Amended Stipulation and Agreement of Settlement, Johnson v. Inos, No. 09-cv-00023 (D. N. Mar. I. Aug. 6, 2013), ECF No. 468.

[125]Order *re* Appointment of Trustee Possessing All Powers of a Federal Receiver, Johnson v. Inos, No. 09-cv-00023 (D. N. Mar. I. Sep. 25, 2013), ECF No. 526.

[126]In the late 1800s federal equity receiverships were the primary means by which railroads, which were expanding across the United States, were reorganized. While, at first, these receiverships were instituted in connection with lawsuits seeking the foreclosure of mortgages, by the late 1900s it had become common for debtor railroads to initiate them when they were insolvent but believed they had going concern value worth preserving. *See, e.g.,* Atkins v. Wabash, 29 F. 161 (Cir. N.D. Ill. 1886); Central Trust v. Wabash, 29 F. 618 (Cir. E.D. Mo. 1886); Wabash v. Central Wabash, Central Trust Co., 22 F. 272 (Cir. E.D. Mo. 1884). The Harvard Law Review noted that:

ships.[127] An insolvent municipal pension fund could potentially achieve simi-

> Since the Wabash case, many like cases have arisen; and it may now be said that the practice is well established; indeed, that under like circumstances it is the almost invariable practice. By this is meant precisely, that when a railway company is in financial straits, or about to be in a case where under the former practice its creditors would be entitled to bring suit to subject its property to a sale for the payment of its debts, and, pending such suit, to ask the appointment of a receiver, the recent practice is for the company itself to anticipate the occurrence of such conditions, and, as the creditors cannot move till they do occur, to seek the court in advance of default, file a petition or bill on its own behalf, and ask the appointment of receivers, usually of its own selection, . . . it is certainly true that the practice is actually followed, so far as we know, in nearly all the courts of the United States, as occasions arise.

D. H. Chamberlain, *New Fashioned Receiverships*, 10 HARV. L. REV., 139, 145-46 (1896). By 1933, in the depths of the Great Depression, "more than fifty railroad companies owning more than twenty thousand miles of railroad in the United States . . . [were] in receivership." Lloyd K. Garrison, *Corporate Reorganization—An Amendment to the Bankruptcy Act—A Symposium*, 19 VA. L. REV., 317, 317-18 (1933).

[127]Railroad equity receiverships developed substantial law about what is fair and equitable. The words "fair and equitable" contained in § 1129(b)(1) of the Bankruptcy Code are "words of art" that are "derived" ultimately from railroad equity receivership decisions. K. KLEE, BANKRUPTCY AND THE SUPREME COURT 370 (2005). Equity receiverships developed the concept that a plan was not fair and equitable if it violated the "absolute priority rule" by permitting old shareholders to receive an interest in the reorganized company on account of their old common stock interests when creditors had not been paid in full. *See, e.g.,* Kansas City Terminal Railway v. Central Union Trust Co., 271 U.S. 445 (1926); Northern Pacific Railway Co. v. Boyd, 228 U.S. 482 (1913); Louisville Trust Co. v. Louisville New Albany & Chicago Railway, 174 U.S. 674 (1899); Railroad Co. v. Howard, 74 U.S. (7 Wall.) 392 (1869).

This concept was carried forward into non-railroad cases under § 77B of the Bankruptcy Act. Bankruptcy Act Chapter VIII (§ 77 railroad reorganizations), 11 U.S.C. § 205 (1976) (repealed 1979). *See, e.g.*, Case v. L. A. Lumber Prods. Co., 308 U.S. 106 (1939); Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1939). It was also carried forward into chapter X of the Bankruptcy Act which was intended to be used by large corporations. Bankruptcy Act Chapter X (Corporate Reorganizations, Bankruptcy Act §§ 101-276), 11 U.S.C. §§ 501-676 (1976) (Repealed 1979). *See, e.g.,* Consol. Rock Prods. Co. v. DuBois, 312 U.S. 510 (1941). Chapter XI of the Bankruptcy Act was meant to apply to smaller, closely held corporations. It did not require application of the rigid absolute priority rule, but used instead an easier best interests of creditors test. Jonathan Hicks, *Foxes Guarding the Henhouse: The Modern Best Interests of Creditors Test in Chapter 11 Reorganizations*, 5 Nev. L. J., 820, 830 (2005). That test would permit old shareholders to participate in a plan of reorganization, even though unsecured creditors were not paid in full, as long as creditors were receiving more than they would receive in a liquidation. As time went on, many large corporate reorganizations were done under chapter XI. *See, e.g.,* U.S. Bankr. Comm'n, Report of the Comm'n on the Bankr. Laws of the U.S., H.R. Doc. No. 93-137, pt. 1, at 245 n.104 (1973). "[Chapter XI] allowed for greater debtor control as well as a standard of fairness determined by the 'best interests' test in lieu of the absolute priority rule." Hicks, *supra,* at 830.

The current Bankruptcy Code enacted in 1978 provides for a chapter 11 debtor to remain in control of its assets during a case and applies both (1) a fair and equitable concept and (2) a best interests of creditors concept. Chapter 9 of the Bankruptcy Code provides for these concepts to be applied to certain governmental entities that fall under the definition of a "municipality." 11 U.S.C. § 901, *et. seq*. Since there are no shareholders of a municipality, courts have given fair and equitable a meaning in municipal cases that does not focus so much on the absolute priority rule (that deals primarily with old shareholder participation in the reorganization), but instead on how much the municipality can reasonably afford to pay. *See, e.g.,* Lorber v. Vista Irrigation Dist., 143 F.2d 282, 284 (9th Cir. 1942*), cert. denied,* 323 U.S. 784 (1944); Fano v. Newport Heights Irrigation Dist., 114 F.2d 563, 563-66 (9th Cir. 1940)). Best interests of creditors concepts have also been applied in municipal restructuring cases but focus on state law remedies

lar relief through a receivership authorized under state law.

b. A Combined State and Federal Approach in a Chapter 9 Case

To wholly resolve both the insolvency of a city and the insolvency of a related pension fund requires either that the pension fund conduct its own financial restructuring in chapter 9 or through some other procedural vehicle such as a receivership, or convince the state legislature to modify both the municipality's funding obligations and the pension fund's benefit payment obligations.

A chapter 9 municipal debtor could pursue a combined approach by asking the state legislature, rather than the bankruptcy court, to make the first decision concerning the modification of statutory pension funding and benefit obligations. During a chapter 9 case, a city could propose a bill to the legislature to amend the applicable pension statutes to change both the city's funding obligations and the pension fund's benefit payment obligations, and condition its plan of debt adjustment on the passage of that legislation. The proposed bill would provide a complete solution to the pension funds' revenue and benefit payment issues, and constitute one element of a broader restructuring of the city's debt in its chapter 9 case. The procedure for proposing such legislation will, of course, vary from state to state and would require sponsorship and support from legislators aligned with the city's efforts to reorganize.

The city's proposed chapter 9 plan and related disclosure statement could show the legislature that the proposed changes to pension rights and obligations are an essential component of a plan that changes other parts of the city's debt structure, reduces other expenses, and raises revenue. These documents might also persuade the legislature that the plan is fairly balanced, in the best interest of pension creditors, and provides pension beneficiaries more than they would receive if the pension funds are allowed to go into default.[128]

If the legislature does not enact a chapter 9 debtor's proposed pension legislation, the city could still resort to the purely federal approach described above, using bankruptcy law to reduce its statutory pension funding obligation, partially pay the resulting unsecured claim, and discharge the unpaid portion pursuant to a chapter 9 plan. The prospect of the city using federal

available against a governmental entity rather than on liquidation of assets. *See, e.g., Asbury Park, supra.* Consequently, a federal equity receivership for an insolvent government entity, that is not authorized to file a chapter 9 case, would have a wealth of authority to rely on for determining what is fair.

[128]As described in greater detail below, a statute reducing pension rights and contribution obligations would need to pass muster as not being an unconstitutional impairment of existing "statutory contract rights." It is an open issue whether a bankruptcy court would have jurisdiction to decide whether an amended state pension statute crucial to the feasibility of a chapter 9 plan under § 943(b)(7) was an unconstitutional impairment of pension contract rights. *See, e.g.,* Stern v. Marshall, 564 U.S. 2 (2011).

bankruptcy law to reduce just its pension funding obligations might motivate legislators to support the city's proposed legislation that would restructure the entire pension system, including both its funding and benefits aspects.

c. A Purely State Approach Where Chapter 9 Relief is Not Available

In a state, such as Illinois, where there is no statute unequivocally granting authority to a municipality to file a chapter 9 case, a municipality would need to deal with labor and bond contracts through negotiation and/or changes to existing state law, unless it can obtain authorization to file chapter 9. A municipality that is not authorized to file a chapter 9 case could still propose a bill to modify the applicable pension statutes, but it would likely need to litigate in state court any claims about whether these changes violate state constitutional prohibitions against impairment. Because federal contract impairment issues would also be present, such a case might be heard in federal court with state constitutional issues treated as pendant claims. Regardless of the venue, legislative action that impacts pension rights will likely be analyzed to determine whether the requested impairment of contract rights is a permissible exercise of the state's police power.

III. ANALYSIS OF STATE POLICE POWER AND CONTRACT IMPAIRMENT

Because there are constitutional limitations on the use of legislation to impair existing contract rights, the jurisprudence that has developed analyzing when modification of contracts is permissible is clearly relevant if a city proposes to amend a state statute adjusting pension funding and benefit obligations. It will also be relevant if the city attempts to alter other contract rights by the use of its police power.

The starting point for any analysis of contract impairment is Article 1, Section 10 of the United States Constitution, known as the "Contract Clause," which provides that "No State shall . . . pass any . . . Law impairing the Obligation of Contracts." Many state constitutions contain similar proscriptions against the impairment of contracts.[129] The seminal case analyzing whether a state has unconstitutionally impaired contract rights by use of its police power to protect public welfare arose during the Great Depression when Minnesota used its police power to keep people in their homes during that economic crisis by legislatively extending homeowners' contractual

[129] *See, e.g.*, TEX. CONST. Art. I, § 16 ("No bill of attainder, ex post facto law, retroactive law, or any law impairing the obligation of contracts, shall be made."); ILL. CONST. Art. 1, Sec. 16 ("No ex post facto law, or law impairing the obligation of contracts or making an irrevocable grant of special privileges or immunities, shall be passed.").

rights to redeem after a foreclosure proceeding.[130]

U.S. Supreme Court cases analyzing whether state legislative action aimed at a public policy problem violates the Contracts Clause have repeatedly focused on (i) the severity of the public problem that prompted the state to take the action, (ii) the extent of the contract impairment, and (iii) the necessity and reasonableness of the method used to address the public policy problem. State case law concerning whether a statute impairs contract rights protected by a state constitution has often relied on the law developed by federal courts analyzing the Contracts Clause.

The simple, common sense analysis developed in contract impairment cases, and applied consistently for over seventy five years, has been in the vanguard of modern jurisprudence dealing with city insolvency. These cases deal with whether labor-related contracts are unconstitutionally impaired when a municipality tries to remedy its insolvency by reducing contract benefits, without resorting to federal bankruptcy law that clearly authorizes impairment of any contract, including obligations to labor and capital providers. They consider whether a state has made reasonable use of alternative mechanisms for addressing insolvency, including reducing other expenditures and raising revenue through increased taxes or otherwise. One older U.S. Supreme Court decision[131] examined whether the challenged state action actually made creditors better off, similar to the best interest of creditors test employed in chapter 9 cases.

If a city, in connection with its chapter 9 case, persuades its state legislature to pass a law modifying constitutionally protected "statutory pension contract rights," the evidence the city would need to introduce with respect to whether the proposed state statute violates constitutional limitations on impairment of contracts would most likely also be sufficient to demonstrate that its chapter 9 plan proposing that treatment is both fair and equitable, and in the best interest of creditors.

A. When Is the State's Exercise of Police Power to Impair Contracts Constitutional?—General Principles.

A state's legislative action does not violate the Contracts Clause simply because it has the effect of relieving one party from performing some of the duties imposed by pre-existing contracts.[132] Although the language of the Contracts Clause appears absolute, the Supreme Court has approved the exercise of a state's police power to alter or amend contracts in certain circumstances, observing that "[i]t is well settled that the prohibition against

[130]Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 417-18 (1934).

[131]*See* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 516 (1942).

[132]Exxon Corp. v. Eagerton, 462 U.S. 176, 190 (1983).

impairing the obligation of contracts is not to be read literally."[133] Indeed, the Supreme Court has stated that:

> [I]t is to be accepted as commonplace that the Contract[s] Clause does not operate to obliterate the police power of the States. . . . This power, which in its various ramifications is known as the police power, is an exercise of the sovereign right of the Government to protect the lives, health, morals, comfort and general welfare of the people, and is paramount to any rights under contracts between individuals.[134]

A seminal case on the interplay between the Contracts Clause and the exercise of a state's police power is *Home Building & Loan Ass'n v. Blaisdell*,[135] in which the appellant challenged the constitutionality of the Minnesota legislature's exercise of its police power in the depths of the Great Depression to extend the time for a mortgagee to redeem a home after foreclosure.[136] Upholding the state's legislative action, which literally kept families off of the streets, the Supreme Court observed that "[t]he legislature cannot 'bargain away the public health or the public morals . . . '", rather "[t]he economic interests of the State may justify the exercise of its continuing and dominant protective power notwithstanding interference with contracts."[137] The question, according to the Supreme Court, was not whether the legislative action affected contracts incidentally or directly, but "whether the legislation is addressed to a legitimate end and the measures taken are reasonable and appropriate to that end."[138]

Although a state can exercise its police power in ways that modify contract rights, that power is not without limits.[139] In *City of El Paso v. Simmons*,[140] the Supreme Court considered a challenge to a Texas statute that limited to five years the previously unlimited time to redeem foreclosed property. The Supreme Court held that the state retains the power to act in the public interest and to protect its citizens, even if its actions impair a con-

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[133]Keystone Bituminous Coal Ass'n v. DeBendictis, 480 U.S. 470, 502 (1987) (citing W.B. Worthen Co. v. Thomas, 292 U.S. 426, 433 (1934)).

[134]Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 241-42 (1978) (quoting Manigault v. Springs, 199 U.S. 473, 480 (1905)).

[135]Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).

[136]*Id.* at 417-18.

[137]*Id.* at 436-37.

[138]*Id.* at 438.

[139]*See* U. S. Trust Co. of N. Y., Tr. v. New Jersey, 431 U.S. 1 (1977) (overturning as an unconstitutional impairment of a contract the retroactive repeal of an inter-state covenant pledging certain revenues as security for bonds issued by the Port Authority in order to use these revenues to pursue a different public purpose).

[140]City of El Paso v. Simmons, 379 U.S. 497 (1965).

tract,[141] and expressed deference to the judgment of the state legislature concerning what is necessary for the public interest.[142] While *El Paso* upheld the Texas legislature's extinguishment of pre-existing unlimited contract redemption rights as an appropriate exercise of police power concerning an issue of public need that was "important" to the state,[143] it also stressed that police power should not be used to entirely repudiate contracts, stating:

> Of course, the power of a State to modify or affect the obligation of contract is not without limit. Whatever is reserved of state power must be consistent with the fair intent of the constitutional limitation of that power. The reserved power cannot be construed so as to destroy the limitation, nor is the limitation to be construed to destroy the reserved power in its essential aspects. They must be construed in harmony with each other. This principle precludes a construction which would permit the State to adopt as its policy the repudiation of debts or the destruction of contracts or the denial of means to enforce them.[144]

Similarly, in *Allied Structural Steel Co. v. Spannaus*,[145] after reiterating that the Contracts Clause is not absolute[146] and describing the state's broad

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[141]The *El Paso v. Simmons* court noted:

> The *Blaisdell* opinion, which amounted to a comprehensive restatement of the principles underlying the application of the Contract Clause, makes it quite clear that "not only is the constitutional provision qualified by the measure of control which the State retains over remedial processes, but the State also continues to possess authority to safeguard the vital interests of its people. It does not matter that legislation appropriate to that end 'has the result of modifying or abrogating contracts already in effect.' Not only are existing laws read into contracts in order to fix obligations as between the parties, but the reservation of essential attributes of sovereign power is also read into contracts as a postulate of the legal order. . . . Moreover, the "economic interests of the State may justify the exercise of its continuing and dominant protective power notwithstanding interference with contracts." The State has the 'sovereign right . . . to protect the . . . general welfare of the people . . .'"

City of El Paso v. Simmons, 379 U.S. 497, 508 (1965) (internal citations omitted).

[142]"Once we are in this domain of the reserve power of a State we must respect the 'wide discretion on the part of the legislature in determining what is and what is not necessary.'" *Id.* at 508-509 (citing E. N. Y. Sav. Bank v. Hahn, 326 U.S. 230, 232-233 (1945)).

[143]*Id.* at 516.

[144]*Id.* at 509.

[145]Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978).

[146]"The Clause is not, however, the Draconian provision that its words might seem to imply. As the Court has recognized, 'literalism in the construction of the contract clause . . . would make it destructive of the public interest by depriving the State of its prerogative of self-protection.'" *Allied Structural Steel Co.*, 438 U.S. at 240 (citing W. B. Worthen Co. v. Thomas, 292 U.S. 426, 433 (1934)).

police power concerning matters that might be subject to contracts,[147] the Supreme Court analyzed the (i) necessity of the legislative action, (ii) the severity of the impairment, and (iii) the reasonableness of the impairment. It held that a pension law imposing a substantial retroactive liability, apparently aimed at one private employer that was shutting down its operations in Minnesota,[148] was an unconstitutional use of police power because it substantially impaired a contract right without adequate justification. The court noted:

> But whether or not the legislation was aimed largely at a single employer, it clearly has an extremely narrow focus. . . . [and] can hardly be characterized, like the law at issue in the *Blaisdell* case, as one enacted to protect a broad societal interest rather than a narrow class. . . . Moreover, in at least one other important respect the Act does not resemble the mortgage moratorium legislation whose constitutionality was upheld in the *Blaisdell* case. This legislation, imposing a sudden, totally unanticipated, and substantial retroactive obligation upon the company to its employees, was not enacted to deal with a situation remotely approaching the broad and desperate emergency economic conditions of the early 1930's—conditions of which the Court in *Blaisdell* took judicial notice.[149]

Thus, to justify a use of police power that has a discriminatory or retroactive effect, there must be proof that the legislative action is necessary to protect a

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[147] It is the settled law of this court that the interdiction of statutes impairing the obligation of contracts does not prevent the State from exercising such powers as are vested in it for the promotion of the common weal, or are necessary for the general good of the public, though contracts previously entered into between individuals may thereby be affected.

Allied Structural Steel Co., 438 U.S. at 241 (quoting Manigault v. Springs, 199 U.S. 473, 480 (1905)).

[148] The law was not even purportedly enacted to deal with a broad, generalized economic or social problem. . . . It did not operate in an area already subject to state regulation at the time the company's contractual obligations were originally undertaken, but invaded an area never before subject to regulation by the State. It did not affect simply a temporary alteration of the contractual relationships of those within its coverage, but worked a severe, permanent, and immediate change in those relationships—irrevocably and retroactively. And its narrow aim was leveled, not at every Minnesota employer, not even at every Minnesota employer who left the State, but only at those who had in the past been sufficiently enlightened as voluntarily to agree to establish pension plans for their employees.

Allied Structural Steel Co., 438 U.S. at 250 (internal citations omitted).

[149] *Id.* at 248-249.

compelling public interest.[150]

Five years later, in *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*,[151] the Supreme Court reviewed a challenge to the Kansas legislature's enactment of the Kansas Natural Gas Protection Act[152] which altered the rights of parties to certain intra-state natural gas contracts, an industry previously subject to regulation,[153] by imposing price controls in response to the deregulation of the natural gas markets in 1978.[154] In holding that the statute was not an unconstitutional impairment of contract, the Supreme Court indicated that the threshold inquiry is "whether the state law has, in fact, operated as a substantial impairment of a contractual relationship."[155]

Although total destruction of contractual expectations is not necessary for a finding of substantial impairment,[156] more severe impairments will be subject to an increased level of scrutiny.[157] According to *Energy Reserves*, if a state regulation constitutes a substantial impairment, "the State, in justification, must have a significant and legitimate public purpose behind the regulation."[158] The state action must be directed at, for example, remedying a broad and general social or economic problem,[159] which need not be limited

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[150]A statute with retroactive effect requires a higher level of scrutiny, but retroactive legislation is not categorically prohibited. For example, the Texas Supreme Court recently held:

> We think our cases establish that the constitutional prohibition against retroactive laws does not insulate every vested right from impairment, nor does it give way to every reasonable exercise of the Legislature's police power; it . . . prevents the abuses of legislative power that arise when individuals or groups are singled out for special reward or punishment. No bright-line test for unconstitutional retroactivity is possible. Rather, in determining whether a statute violates the prohibition against retroactive laws in *article I, section 17 of the Texas Constitution*, courts must consider three factors in light of the prohibition's dual objectives: the nature and strength of the public interest served by the statute as evidenced by the Legislature's factual findings; the nature of the prior right impaired by the statute; and the extent of the impairment. . . . There must be a compelling public interest to overcome the heavy presumption against retroactive laws.

Robinson v. Crown Cork & Seal Co., Inc., 335 S.W.3d 126, 145-46 (Tex. 2010); *see also In re* A.V., 113 S.W.3d 355, 361 (Tex. 2003) (approving as a valid use of police power a statute that retroactively permitted the termination of parental rights of incarcerated felons even though their imprisonment pre-dated the statute); Barshop v. Medina, 925 S.W.2d 618, 633-34 (Tex. 1996) (retroactive restriction of pre-existing water rights to protect to safeguard public safety and welfare and the economic development of the state was a valid use of police power).

[151]Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400 (1982).

[152]1979 KAN. SESS. LAWS, ch. 171, codified as *Kan. Stat. Ann.* §§ 55-1401 to 55-1415 (Supp. 1982).

[153]Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 411 (citing *Allied Structural Steel Co.*, 438 U.S. at 242, n. 13).

[154]*Id.* at 415.

[155]*Id.* at 411.

[156]*Id.* (citing *U. S. Trust Co.,* 431 U.S. at 26-27).

[157]*Id.* (citing *Allied Structural Steel Co.*, 438 U.S. at 245).

[158]*Id.* at 411-12 (citing *U. S. Trust Co.*, 431 U.S. at 22).

[159]*Id.* at 412 (citing *Allied Structural Steel Co.*, 438 U.S. at 247, 249).

solely to an emergency or temporary situation.[160] By requiring that there must be a legitimate public purpose behind state action, the law guarantees that a state's exercise of its police power will inure to the benefit of the public, rather than providing a benefit to special interests.[161]

The final factor discussed in *Energy Reserves'* Contracts Clause analysis is whether the adjustment of "the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption."[162] The Supreme Court reiterated that, as a general principle, when reviewing economic and social regulation, it is proper for courts to defer to legislative judgment as to the necessity and reasonableness of a particular measure.[163] However, when a state itself has entered into the contract at issue, "complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the state's self-interest is at stake."[164]

Beginning with *Blaisdell*, and applied consistently thereafter, the Supreme Court's analysis of the constitutionality of a state's impairment of contract rights has included three general inquiries: (1) How substantially is a contract obligation impaired?; (2) Is the impairment necessary to solve a substantial public problem?; and (3) Is the impairment a reasonable way of actually solving the problem?[165]

B. Police Power and Contract Impairment in the Context of Municipal Insolvency

When a municipality is insolvent, there is conflict between the protection of contract rights under the Contracts Clause and the exercise of police power by a state or local government to deal with the insolvency. Courts considering whether a municipality may impair public contracts to deal with

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[160]*Id.* (citing *U. S. Trust Co.*, 431 U.S. at 22 n.19).

[161]*Id.* (citing *Allied Structural Steel Co.*, 438 U.S. at 247-248, 248 n.20).

[162]*Id.* (citing *U. S. Trust Co.*, 431 U.S. at 22) (emphasis added).

[163]*Id.* at 413 (citing *U. S. Trust Co.*, 431 U.S. at 22-3).

[164]*Id.* (quoting *U. S. Trust Co.,* 431 U.S. at 26).

[165]*See* United Healthcare Ins. Co. v. Davis, 602 F.3d 618 (5th Cir. 2010) (challenged state statute was designed to benefit a specific in-state corporation, lacked adequate justification, and was a violation of the Contracts Clause); Lipscomb v. Columbus Mun. Separate School Dist., 269 F. 3d 494 (5th Cir. 2001), *cert. denied* 535 U.S. 998 (2002) (finding a state's attempt to void school land leases would violate the Contract Clause); Exxon v. Eagerton, 462 U.S. at 191 (applying *Allied Structural Steel*); General Motors v. Romein, 503 U.S. 181, 186 (1991) (applying *Allied Structural Steel and Energy Reserves Group*); Chi. Bd. of Realtors v. City of Chicago, 819 F.2d 732, 735-7 (7th Cir. 1987) (additional real estate regulations at issue were in an already highly regulated area, did not materially impair contract rights, and represented a reasonable allocation of rights and responsibilities between landlords and tenants that the city rationally could have believed would serve a public purpose); *Chrysler Corp. v. Kolosso Auto Sales Inc.*, 148 F.3d 892 (7th Cir. 1998); Wis. Cent. Ltd. v. Pub. Serv. Comm'n. of Wis., 95 F.3d 1359 (7th Cir. 1996); *see also* Paul M. Secunda, *Constitutional Contract Clause Challenges in Public Pension Litigation*, 28 Hofstra Labor & Emp. L. J., 227, 263 (2011).

dire financial challenges have articulated principles for developing an acceptable restructuring plan that are remarkably similar to chapter 9 concepts.

In *Faitoute Iron & Steel Co. v. City of Asbury Park*,[166] the Supreme Court reviewed the constitutionality of a state receivership procedure dealing with bond debt that the city could no longer afford to pay. During the Great Depression, the state of New Jersey enacted a statute authorizing a state receivership procedure for insolvent local governments.[167] Under that statute, a debt restructuring plan would be binding on non-consenting creditors if (i) it was approved by the municipality, by a state agency and by creditors holding 85% of the debt; and (ii) a state court conducted a hearing and found that the plan was "in the best interest of all of the creditors" affected by the plan.[168]

Under the plan in *Asbury Park*, the holders of revenue bonds received new securities bearing lower interest rates, and later maturity dates, than contracted for in their original bonds.[169] Dissenting bondholders challenged the constitutionality of the statute under the Contracts Clause, arguing that the original bonds issued by the city constituted contracts and the statute had unconstitutionally changed the terms of the bonds without their consent.[170]

The Supreme Court rejected the dissenting bondholders' Contracts Clause objections finding that the old bonds represented only theoretical rights because the municipality could not, as a practical matter, raise its taxes enough to pay off its creditors under the original contract terms.[171] The Supreme Court held that a state has the right to use its police power to create a reasonable process for the payment of municipal debts[172] and, as part of the exercise of that power, a state can modify the terms for the payment of

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

[167]The receivership law was instituted after the U.S. Supreme Court struck down a recently enacted federal municipal bankruptcy act in *Ashton v. Cameron Cnty. Water Improvement Dist. No. 1,* 298 U.S. 513 (1936) and before the enactment of a revised municipal bankruptcy act was approved in *U. S. v. Bekins,* 304 U.S. 27 (1938).

[168]*Id.* at 504.

[169]*Id.* at 507.

[170]*Id.* at 507-09.

[171]*Id.* at 515-16.

[172] If a State retains police power with respect to building and loan associations . . . because of their relation to the financial well-being of the State, and if it may authorize the reorganization of an insolvent bank upon the approval of a state superintendent of banks and a court, . . . a State should certainly not be denied a like power for the maintenance of its political subdivisions and for the protection not only of their credit but of all the creditors by an adjustment assented to by at least 85 percent of the creditors, approved by the commission of the State having oversight of its municipalities, and found wise and just after due hearing by a court.

Id. at 513-14 (internal citations omitted).

those debts without violating constitutional prohibitions against contract impairment.[173]

The Supreme Court determined that, particularly given the complaining creditors' poor alternative state law remedies,[174] the receivership's restructuring plan had actually preserved the value of the creditors' bonds.[175] The court observed that "[t]he question whether the remedy on this contract was impaired materially is affected not only by the precarious character of the plaintiff's right, but by considerations of fact—of what the remedy amounted to in practice."[176] It held there was *no actual impairment* where the state restructuring procedure, though it altered the contract rights, had actually resulted in the bonds having more value than they had had prior to the restructure.[177] Thus, in the first contract impairment case to deal directly with municipal insolvency, the Supreme Court expressed a clear preference for a comprehensive plan of debt adjustment, especially one that averted disastrous default and resulted in creditors being paid more than they would receive in the event of a default.[178]

In *Baltimore Teachers Union v. Mayor of Baltimore*,[179] the city, faced with substantial reductions in state aid, instituted a variety of measures, including layoffs, elimination of positions, and early retirements to deal with its budgetary shortfall.[180] When it suffered a subsequent cut in state aid, the city im-

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[173] But if taxes can only be protected by the authority of the State and the State can withdraw that authority, the authority to levy a tax is imported into an obligation to pay an unsecured municipal claim, and there is also imported the power of the State to modify the means for exercising the taxing powers effectively in order to discharge such obligation, in view of conditions not contemplated when the claims arose. *Impairment of an obligation means refusal to pay an honest debt; it does not mean contriving ways and means for paying it.* The necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city's debt is implied in every such obligation for the very reason that *thereby the obligation is discharged, not impaired.*

Id. at 511 (emphasis added).

[174] *Id.* at 510.

[175] *Id.* at 513.

[176] *Id.* at 514 (quoting Pittsburgh Steel Co. v. Balt. Equitable Soc., 225 U.S. 455, 459 (1913)).

[177] *Id.* at 516.

[178] Some courts have questioned *Asbury Park*'s precedential value because only the federal government can pass a statute providing for a bankruptcy reorganization that permits contract impairment. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 27-8 (1977); *In re* Jefferson Cnty., Ala., 474 B.R. 228, 279 (Bankr. N.D. Ala. 2012), *aff'd sub nom.* Mosley v. Jefferson Cnty. (*In re* Jefferson Cnty.), 2012 WL 3775758 (N.D. Ala. Aug. 28, 2012); *In re* City of Detroit, *supra* note 15, "Opinion Regarding Eligibility," Docket No. 1945, at 64-5. However, no case that distinguishes or limits *Asbury Park* does so on grounds that criticize its substantive holding that unsecured municipal bondholders have limited contract remedies and that the modification of the bondholder's contractual rights was not an unconstitutional impairment where the new terms paid the bondholders more than they would receive if the city had not restructured its obligations.

[179] Balt. Teachers Union v. Mayor of Baltimore, 6 F.3d 1012 (4th Cir. 1993).

[180] *Id.* at 1014.

plemented a furlough plan under which it ultimately reduced the annual salaries of its employees by approximately 1%. The city's teachers' and police unions challenged this action as an unconstitutional impairment of their contract rights set out in their collective bargaining agreements.[181]

Based in large measure on the city's broad use of many and varied types of cost cutting measures to address its insolvency, the Fourth Circuit affirmed the city's actions as a reasonable exercise of police power, holding that:

> In light of the magnitude and timing of the proposed cuts in state funding that prompted the City's salary reductions, the undisputed legitimacy of the City's need to balance its budget, *the City's concerted efforts to exhaust numerous alternative courses of cost reduction before resorting to the challenged reductions*, the circumscribed nature of the furlough plan, and the City's immediate abandonment of the reductions at the first opportunity, we believe—according the legislature some deference but without accepting its assertions uncritically—that Baltimore's plan was, as it must be, "upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption." *United States Trust*, 431 U.S. at 22. Accordingly, we conclude that the City's modification of its employees' contracts was an impairment permitted by [the Contract Clause].[182]

More recently, in *Buffalo Teachers Federation v. Tobe*,[183] the Second Circuit reviewed the state legislature's enactment of a statute that gave the Buffalo Fiscal Authority power to review Buffalo's budgets and take necessary corrective steps, including instituting wage freezes for city employees in conflict with existing labor contract rights.[184]

The New York legislature had determined that Buffalo faced a "state of fiscal crisis" given its continually increasing budget deficits and that the statute was necessary to preserve essential services and the "long-term fiscal health" of the city, region, and state.[185] After teacher lay-offs and tax increases failed to cure the city's budget deficit, the Buffalo Fiscal Authority instituted a wage freeze that precluded a two percent wage increase agreed to in applicable labor contracts.[186] Multiple unions sought declaratory and injunctive relief and alleged, among other things, that the wage freeze vio-

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[181]*Id.*
[182]*Id.* at 1022 (emphasis added).
[183]Buffalo Teachers Fed'n. v. Tobe, 464 F.3d 362 (2d Cir. 2006).
[184]*Id.* at 366.
[185]*Id.*
[186]*Id.*

lated the Contracts Clause.[187]

The circuit court noted that the plaintiffs had the burden of establishing that the state action was motivated by the "state's self-interest rather than the general welfare of the public."[188] It found that the plaintiffs had not met that burden, that the record showed the state action dealt with a real and immediate financial crisis, and that the impairment at issue was reasonable in light of the other alternatives the city had considered and tried.[189]

The Second Circuit applied the Supreme Court's three-factor contract impairment test and rejected the Contracts Clause challenge. The court quickly disposed of the first two factors, finding the wage freeze was a "substantial impairment" and the statute served a "legitimate public purpose" in combating an admitted financial crisis.[190]

With respect to the third factor, the reasonableness of the state action, the court applied a higher, less deferential standard because the state itself was a party to the affected contract.[191] To that end, the court held "it must be shown that the state did not (1) 'consider impairing the . . . contracts on par with other policy alternatives' or (2) 'impose a drastic impairment when an evident and more moderate course would serve its purpose equally well,' nor (3) act unreasonably 'in light of the surrounding circumstances.'"[192]

The court held the wage freeze satisfied the first two of these additional factors because it was instituted as a "last resort measure" after other alternatives (including employee cuts, school closures, and tax increases) were tried unsuccessfully.[193] The court further held the wage freeze satisfied the reasonableness factor because it caused a "relatively minimal" impairment and was prospective only.[194] Finally, the court declared it would not "second-guess the wisdom" of the state's chosen remedy where the state had reasonably balanced the alternatives.[195]

In *United Automobile, Aerospace, Agricultural Implement Workers Of*

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[187]*Id.* at 365.

[188]*Id.*

[189]"An emergency exists in Buffalo that furnishes a proper occasion for the state and Buffalo Fiscal Authority to impose a wage freeze to 'protect the vital interests of the community,' and the existence of the emergency 'cannot be regarded as a subterfuge or as lacking in adequate basis.'" *Id.* (quoting *Blaisdell*, 290 U.S. at 444).

[190]*Id.* at 368.

[191]*Id.* at 370. The Court expressly stated that it was not deciding whether the higher standard was warranted when a city or other subsidiary of the state rather than state itself is the contract counterparty, noting that resolution of that issue was unnecessary because the wage freeze satisfied even the higher standard. *Id.*

[192]*Id.* at 371 (quoting *U. S. Trust Co.*, 431 U.S. at 30-31).

[193]*Id.* at 371-72.

[194]*Id.*

[195]*Id.* at 372.

America International Union v. Fortuno,[196] the First Circuit upheld a Rule 12(b)(6) dismissal of a contract impairment challenge to a Puerto Rican statute entitled "Law Declaring a Fiscal State of Emergency and Establishing a Comprehensive Fiscal Stabilization Plan to Save Puerto Rico Credit" that reduced the government payroll (in violation of existing collective bargaining agreements) and raised taxes and other revenue, for the stated purpose of eliminating Puerto Rico's $3.2 billion structural deficit.[197]

Acknowledging its obligation to analyze the extent, necessity, and reasonableness of the contract impairment, the First Circuit held that, even though a state is subject to a higher level of scrutiny when it is a party to the contract being impaired, a plaintiff alleging that a state's contract impairment is unnecessary and unreasonable bears the burden of alleging sufficient supporting facts.[198] The Court held the plaintiffs' pleadings failed to meet that burden and upheld the dismissal of the plaintiffs' claims of unconstitutional contract impairment.[199] The First Circuit's holding, that "where plaintiffs sue a state—or in this case the Commonwealth of Puerto Rico—challenging the state's impairment of a contract to which it is a party, the plaintiffs bear the burden on the reasonableness/necessary prong of the Contract Clause analysis,"[200] was based on its conclusions that the state had acted reasonably and was entitled to judicial deference.

> The fact that the Contract Clause has traditionally been interpreted to avoid limiting a state's ability to govern effectively also weighs in favor of assigning this burden to the plaintiffs. To demand that the state prove reasonableness and necessity would force governments to endure costly discovery each time a plaintiff advances a plausible allegation of a substantial impairment, even where that plaintiff cannot allege a single fact to question the reasonableness or necessity of the impairment. This would not only financially burden states, it would likely discourage legislative action impacting public contracts. Such a result is particularly undesirable in today's fiscal environment, where many states

[196]United Auto. Aerospace, Agric. Implement Workers Of Am. Int'l Union v. Fortuno, 635 F.3d 37 (1st Cir. 2011).

[197]*Id.* at 39.

[198]*Id.* at 42.

[199]The Court found that (1) the plaintiffs failed to properly plead the extent of the contract impairment by failing to list the affected contracts and alleged impairments, (2) the plaintiffs' bare assertion that "the averred purpose [of the law dealing with a $3.2 billion deficit] is neither significant nor legitimate" was inadequate to contest the necessity of the legislation, and (3) plaintiffs did not meet their burden of placing the reasonableness of the state's actions in issue by merely pleading that there were other less drastic alternatives available without specifying any such alternatives. *Id.* at 46-7.

[200]*Id.* at 42.

> face daunting budget deficits that may necessitate decisive and dramatic action. *Cf. Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 443-44, 54 S. Ct. 231, 78 L.Ed. 413 (1934) ("[T]he court has sought to prevent the perversion of the clause through its use as an instrument to throttle the capacity of the states to protect their fundamental interests. This development is a growth from the seeds which the fathers planted.").[201]

Asbury Park, *Baltimore Teachers Union*, *Buffalo Teachers Federation* and *Fortuno* establish touchstone principles for discerning whether modifications to public employee wages and public bond debt are constitutional impairments of contract. Similar principles apply when a municipality seeks to modify statutorily defined pension benefits.

In *Felt v. Board of Trustees of the Judges Retirement System*,[202] the Illinois legislature, concerned that the state's judicial retirement system was not adequately funded,[203] enacted a retrospective change to the formula for calculating judicial pensions. Pension beneficiaries challenged the legislatively mandated change. In adjudicating the challenge, the Illinois Supreme Court recognized that "the contract clause does not immunize contractual obligations from every conceivable kind of impairment or from the effect of a reasonable exercise by the States of their police power."[204] The Court ultimately found, however, that the amendment of the pension statute was not a reasonable exercise of the state's police powers because the record did not demonstrate that the amendment was a necessary or reasonable solution to the alleged underfunding of the pension.[205] This case is important for its determination that police power can be used to remedy the insolvency of a pension system, even if contract rights are impaired, but only if the party supporting the statutory change makes the requisite showing of necessity and reasonableness.

These principles have recently been applied in a case involving a challenge to pension reform legislation enacted in a U.S. territory. In *Hernandez, et al. v. Commonwealth et al.*,[206] the Supreme Court of Puerto Rico, applying the U.S. Supreme Court's contract impairment analysis, held that changes to the Puerto Rican government employees' pension system were not unconsti-

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[201]*Id.* at 43.

[202]Felt v. Bd. of Trs. of the Judges Retirement Sys., 481 N.E.2d 698 (1985).

[203]*Id.* at 702.

[204]*Id.* at 701 (quoting George D. Hardin. Inc. v. Village of Mount Prospect, 457 N.E. 429, 432 (1983)).

[205]*Id.* at 702.

[206]Hernandez v. Commonwealth, 2013 PR Sup LEXIS 77 (P.R. 2013). An official English translation of this opinion is not yet available. All quotations in this article to that opinion are from a translation generated through Google Translate *available at* http://translate.google.com.

tutional[207] because they were reasonable and necessary.[208]

Facing unfunded pension liabilities of over $37 billion and a threatened downgrade of the government's credit rating,[209] the legislature of Puerto Rico enacted pension reform legislation that substantially impaired existing pension rights largely through prospective changes.[210] The court recognized the importance of the pension issue to employees and retirees[211] and to the solvency of Puerto Rico.[212] Citing the *U.S. Trust* case, the court stated that the prohibition against the impairment of contracts is not absolute, and that to determine whether legislation impairing contracts is permissible it must analyze (1) the degree of impairment, (2) whether the impairment is necessary to advance a legitimate public interest, and (3) the reasonableness of the change to the contract terms.[213] Moreover, because the government was, itself, a party to the obligation being modified, the state had to demonstrate the legislation was "required to advance an important governmental purpose."[214]

Noting that the constitutionally protected contract rights at issue had to be harmonized with the state's need to insure the "stability and solvency of the system,"[215] the court found "the reform of the retirement system is constitutional because, while there is a substantial impairment of the contractual obligations in controversy, the implemented measures are reasonable and nec-

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[207]The constitution of Puerto Rico contains language identical to the U.S. Constitution's Contracts Clause. *See* P.R. CONST., art II., § 7; Castro v. Commonwealth, 178 D.P.R. 1, 81 (2010), *cert. denied*, 131 S. Ct. 152, 2010 U.S. LEXIS 5781 (2010); Warner Lambert Co. v. Superior Court, 101 D.P.R. 378, 395 (1973).

[208]*Hernandez*, 2013 PR Sup LEXIS 77 at *12.

[209]*PR Top Court Upholds Pension Reform*, CARIBBEAN BUS., June 24, 2013, *available at* www.caribbeanbusinesspr.com/news03. php? nt_ id=85970&ct_id=1.

[210]The legislation (1) froze the further accumulation by current employees of benefits in the defined benefit plan, (2) increased retirement age, (3) increased required employee pension contributions, (4) moved current employees to a defined contribution plan for future accruals, and (5) changed benefits granted by certain special laws and used the savings to provide more funding to the public employee retirement system. *Hernandez*, 2013 PR Sup LEXIS 77 at *3-4.

[211]The Puerto Rican pension system currently covers more than 130,000 public workers and more than 116,000 retirees. *PR Top Court Upholds Pension Reform*, CARIBBEAN BUS., June 24, 2013, *available at* www.caribbeanbusinesspr.com /news03.php? nt_ id=85970&ct_id=1.

[212] All that are in the public service have family, colleagues and partners and friends . . . affected by this legislation. On the other hand, we know the importance that has the resolution of these cases on the economic situation of the country, in particular, on the debt of the State that allows [it] to access funds for the development and maintenance of infrastructure and other programs of singular importance for all who live in Puerto Rico. The [Court] is required to adjudicate the cases before us and do that delicate balance between some conflicting interests of extreme importance in our lives as a people.

Hernandez, 2013 PR Sup LEXIS 77 at *2.

[213]*Id.* at *9.

[214]*Id.*

[215]*Id.* at *10.

essary to safeguard the actuarial solvency of the retirement system, and there are no less onerous measures to achieve that end."[216]

In reaching that decision, the court deferred to the determination of the legislature with respect to the necessity and reasonableness of the statute.[217] It observed that "multiple measures adopted [by the legislature] over the years have failed to solve the financial crisis in the retirement system"[218] and that, prior to adopting the challenged modifications, the legislature had considered other types of solutions and concluded they were not feasible and would not, by themselves, remedy the actuarial crisis.[219]

Finding that "integrated and comprehensive solutions in which all the constituent parts of the system and all taxpayers contribute to the salvation of the same" were required,[220] the court observed that the new law made only prospective changes, not affecting people already retired, and had the effect of saving the system from collapse where all beneficiaries would have been worse off:

> On the other hand, the Statute is clear that the reform of the retirement system is of prospective application and that it does not affect the pension of [existing] retirees. [The Statute also] ensures [that] . . . the participants of the system [will] enjoy a pension at the time . . . [they] retire as a result of these measures. . . . this would not be a possibility without this reform which seeks to avoid [the] insolvency and meltdown of the system and the degradation of the credit of Puerto Rico with its disastrous consequences on the economy.[221]

In holding that the substantial impairment to public pension rights was constitutionally permissible, the court praised the "comprehensive" nature of the legislature's actions and applied an equivalent of the best interests of creditors test used by the Supreme Court in *Asbury Park*, finding that the new pension law prevented a collapse of the pension system and, consequently, increased the value of the pension benefits going forward.

IV. SUMMARY OF STATE AND FEDERAL POWERS AVAILABLE TO RESTRUCTURE MUNICIPAL DEBT

What can city and state leaders learn from the law concerning the use of

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[216]*Id.* at *13.
[217]*Id.* at *14.
[218]*Id.* at *12.
[219]*Id.* at *15.
[220]*Id.*
[221]*Id.*

state police power and confirmation of chapter 9 plans to help them overcome insolvency? Courts have authorized cities to use police power to restructure debt where it was directed primarily to labor contracts, but only if those changes were necessary, undertaken as a last resort, and justified as part of a broader, reasonable plan. Bankruptcy law permits the impairment of contracts in a comprehensive chapter 9 plan that is fair and equitable, does not discriminate unfairly, and provides creditors a better recovery than they would receive outside of bankruptcy.

These obviously similar sets of principles provide two different methods for overcoming municipal insolvency. Both can be used to help a city resolve its financial issues. The bankruptcy alternative is obviously more comprehensive and potent. However, much can be accomplished through the use of state police power, and cases approving its use have been at the forefront of city insolvency jurisprudence and provide insight into the kind of restructuring plan a city should propose to achieve sustainable solvency in the face of significant labor, pension, and capital obligations.

A. Police Power and Contract Impairment

If a city chooses to use police power to restructure, or the use of police power is its only option, it will be limited to contractual modifications that stop short of unconstitutional impairment. Changes to contracts will be judged according to the straightforward analysis first developed during the Great Depression in cases involving foreclosure rights and municipal bonds.[222] To determine whether a proposed contract modification rises to the level of an unconstitutional impairment of contract, a court will consider:

1. Is the proposed change to a contract right part of a larger plan that will improve the return for stakeholders, *i.e.*, is there, in fact, any impairment?
2. How substantial is the contractual impairment?
3. Is the proposed use of police power necessary to solve a major public problem?
4. Is the proposed use of police power a reasonable way of solving the problem?

Municipalities, reluctant or unable to file chapter 9, have often tried to overcome budget crises by focusing on reductions in labor-related expenses. Consequently, much of the jurisprudence related to city restructuring is found in recent contract impairment cases that have dealt primarily with the labor portions of a city's financial structure (reductions to wages and pension funding). These cases have added the following inquiries to the general analysis outlined above:

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[222]*See Asbury Park* and *Blaisdell* and its progeny cited in Section III, A & B, above.

5. Is the city proposing a drastic impairment of labor contracts when a more moderate modification would suffice?
6. Are the changes to labor-related contracts being proposed as a first effort at resolving the insolvency dilemma, or are the changes being proposed as a last resort after the city has already made diligent efforts to cut costs and raise revenues that turned out to be insufficient?
7. Are the changes to labor-related contracts being proposed as part of a broader plan to achieve solvency that includes other methods of cutting expenses and raising revenues?
8. Is the proposed action reasonable "in light of the surrounding circumstances?"

Restructuring pension funding obligations may require changing state statutes that specify the benefits that a pension fund must pay to retirees and the funding that a city must pay to the pension fund. In many states, the right to pension benefits from a pension fund is considered a "contract right" protected from impairment under the U.S. and state constitutions. Legislation changing such rights will probably be scrutinized under the eight-part analysis described above to determine whether it is an unconstitutional impairment of contract. If the legislation prevents a larger default under which pension beneficiaries would receive less than they would receive under the proposed legislation, the Supreme Court's opinion in *Asbury Park* provides a basis for finding that it is not even an actual impairment of contract rights, much less an unconstitutional impairment.

B. Chapter 9

If a city chooses to use federal bankruptcy power, it can achieve a comprehensive restructuring of its finances. In contrast to the piecemeal approach available through the use of state police power alone, in a chapter 9 bankruptcy case a city can breach contracts and restructure all of a city's debts, including labor and bond claims. A chapter 9 plan is confirmable over objection if it (i) is in the best interests of creditors, (ii) is fair and equitable, (iii) is feasible, and (iv) does not discriminate unfairly. The discharge of unsecured debt available in a confirmed chapter 9 plan gives a municipality the power to fundamentally rebalance its finances and eliminate structural insolvency.

As the Supreme Court said in the *Asbury Park* case, a municipality can prove that a restructuring plan meets the "best interests of creditors" test if it proposes to pay its creditors more than they could get by exercising their non-bankruptcy law remedies.

To establish that its plan is "fair and equitable" to unsecured creditors, a municipality must prove that it is paying "all it can reasonably afford" so that

unsecured creditors will be paid "all they can reasonably expect under the circumstances." To prove this, a city will need evidence that it has exercised sound governmental discretion to spend money reasonably and efficiently on necessary municipal functions, to make reasonable reductions in spending, and to make reasonable use of taxation.

Implicit in the evidence showing that a municipality is paying all it can reasonably afford, is proof that the plan is "feasible"—that after confirmation it will be able to pay its creditors what it has proposed in the plan while continuing to operate effectively and provide appropriate services to its citizens.

A municipality can demonstrate that its plan does not discriminate unfairly by proposing that all creditors share the burden of restructuring, rather than singling out labor or capital. This is in keeping with contract impairment cases holding that a city's restructuring efforts should not focus solely on modifying labor-related contract rights.[223]

As part of a chapter 9 plan, a city can reject contracts it believes are obstacles to a successful debt restructuring, and must pay unsecured creditors as much as the city can reasonably afford. To deal with pension funding issues, a chapter 9 debtor might propose as part of its plan of debt adjustment that the state legislature enact an amended pension statute that modifies both pension benefits and the city's funding obligations. This would be just one element of a broader plan that provides for the discharge of other debt, measures to raise revenue, and steps to conform the pension funds' benefit payment obligations to the city's modified funding obligations. By including state legislation to modify pension obligations as part of its overall debt adjustment strategy, a city can achieve a comprehensive solution, addressing both its insolvency and the insolvency of its related pension funds.

If a city cannot garner enough political support for such a complete solution, it has the option of restructuring just the claims against it for pension funding, treating those obligations the same as private contract rights that are partially dischargeable in bankruptcy.

Only in chapter 9 can a municipality receive the discharge of debt necessary to reduce its debt load to an affordable and sustainable level. Outside of bankruptcy, a municipality does not have the right to discharge debts it cannot afford to pay and, thus, is unable to fundamentally change its capital structure to achieve long term stability without creditors' consent. In a chapter 9 case, where a debtor is authorized to breach all contracts, a municipality can compel its creditors to accept the reductions reasonably necessary to achieve sustainable solvency.

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[223]*See generally* Lorber v. Vista Irrigation Dist., 127 F.2d 628 (9th Cir. 1942); Fano v. Newport Heights Irrigation Dist., 114 F.2d 563 (9th Cir. 1940).

V. CONCLUSION: HOW A CITY CAN USE BOTH STATE AND FEDERAL POWER TO RESTRUCTURE ITS FINANCES AND ACHIEVE SOLVENCY

A city can maximize its chances of persuading the public, its creditors (including its employees), the legislature, and the courts, to approve its proposed restructuring plan if that plan overcomes insolvency in a sustainable way, pays creditors all the city can reasonably afford to pay, and does not unfairly discriminate against one kind of creditor. Consequently, when a city makes its financial restructuring proposals, it should be prepared to:

1. Show that it has made reasonable efforts to redirect funds from the delivery of services to the payment of its debt obligations, and that efforts to cut spending on services further would be counterproductive;
2. Show that it has made reasonable use of taxation to raise funds to pay its debt obligations, and that efforts to raise taxes further would be counterproductive;
3. Show that it will modify labor contracts and pension funding obligations in a reasonable fashion with minimal retroactive impact on already retired employees, and that the replacement contracts for current employees are fair and reasonable; and
4. Show that the city's plan will pay unsecured claims, including labor contract rejection claims and bond claims, all the city can reasonably afford to pay given the limits on its ability to cut expenditures and raise taxes.

The principles developed in the contract impairment and bankruptcy cases discussed in this article encourage use of a broad based plan that spreads the financial burden necessary to overcome a city's insolvency among all of the city's major constituencies.

If they wish to lead their cities to solvency, municipal leaders have two potent powers available. They can use state police power to change the terms of contracts the city cannot afford, limited by the prohibition against unconstitutional impairment of those contracts. They can also use federal bankruptcy power available in chapter 9 to breach contracts and to discharge unsecured debt that the city cannot afford to pay. Chapter 9 is obviously more powerful, but police power is a valuable resource that is always available.

City leaders confronting municipal insolvency should realistically assess their city's capital structure and cash flows. From that analysis, they can develop a plan to achieve fundamental, sustainable solvency, and use the full power of their office, supplemented by state police power and federal bankruptcy power, if necessary, to implement that plan.