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CALPERS MAY PREVAIL DESPITE BANKRUPTCY JUDGE'S WARNING IN *CITY OF STOCKTON, CALIFORNIA* THAT FAILURE TO IMPAIR PUBLIC PENSION OBLIGATIONS MAY CONSTITUTE "UNFAIR DISCRIMINATION" IN PLAN OF ADJUSTMENT

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Municipalities long have had little appetite to reel in public pension obligations even in Chapter 9 bankruptcy proceedings. Eyes are currently on a case of first impression, the City of Stockton (the "City"), California (the "State") bankruptcy,[3] to see if the City will be compelled to seek impairment of its obligations to the California Public Employees Retirement System ("CalPERS"). In holding that the City was an eligible "debtor" under Bankruptcy Code § 109(c), Chief Judge Christopher M. Klein pushed off until plan confirmation the issue of whether the City's decision to assume its pension obligations to CalPERS will result in impermissible "unfair discrimination" against the impaired claims of public bondholders, and the inability to confirm a plan of adjustment.[4]

BANKRUPTCY COURT'S POWER TO IMPAIR VESTED PUBLIC PENSION OBLIGATIONS

Outside of bankruptcy, government entities are barred from reducing or eliminating vested pension obligations as *contractual obligations* owed to beneficiaries that cannot be impaired by the state due to the constraint of the Contracts Clause of the United States Constitution and similar provisions in state constitutions.[5]

In two decisions, Judge Klein rejected the argument that the bankruptcy court does not have the power to impair such vested contractual rights vis-à-vis the beneficiaries.[6] In an adversary proceeding, eight retirees argued that they held vested contractual rights to health benefits protected from impairment by the Contracts Clause of the United States Constitution, the contracts clause in the California Constitution, and by other provisions of California law.[7] The Court began its analysis noting that "[w]hile the Contracts Clause is a key navigational star in the firmament of our Constitution and economic universe, it is subject to being eclipsed by the Bankruptcy Clause" which grants Congress the authority to establish uniform bankruptcy laws throughout the United States.[8] The Court explained that it was "no accident" that the Contracts Clause bans a *state* from making a law impairing the obligation of a contract but not Congress as, by necessity, "bankruptcy law entails impairment of contracts."[9] Furthermore, federal bankruptcy power, by operation of the Supremacy Clause, trumps the contracts clause in the California state constitution.[10] The Court, thus, concluded that "even if the plaintiffs' benefits are vested property interests, the shield of the Contracts Clause crumbles in the bankruptcy arena."[11]

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The power of the bankruptcy court to impair such vested contractual obligations, however, can only be exercised if the State and City *consent* to such impairment. As Judge Klein explained, the Bankruptcy Code's chapter 9 provisions are carefully crafted to recognize the balance of the state-federal relationship and the reservation of rights to the States in the 10th Amendment.[12] The Bankruptcy Code honors the state-federal balance by requiring consent of the state and municipality for the bankruptcy filing,[13] permitting only the municipality to propose a plan of adjustment,[14] reserving certain powers to the state controlling the municipality under § 903,[15] and limiting the powers of the federal court under § 904 absent the municipality's consent.[16] Considering this backdrop and the constitutional boundaries of federal courts, Judge Klein held that § 904 prevented the bankruptcy court from interfering with the City's decision to cut the retirees' vested health benefits.[17]

Notwithstanding such required consent, Judge Klein recognized that the City cannot "cherry pick" the application of Bankruptcy Code provisions that apply to it in bankruptcy.[18] As an example, he noted that a state cannot immunize bond debt held by the state from impairment in federal bankruptcy.[19] Therefore, while the bankruptcy court cannot force the City to impair its pension obligations without its consent (and the State may be able to prohibit such action), neither the State nor the City have the power to immunize the City's pension obligations from impairment if the City seeks to confirm a plan of adjustment.

"UNFAIR DISCRIMINATION" POTENTIAL BAR TO CONFIRMATION

With respect to a potential plan of adjustment, Judge Klein foreshadowed potentially serious issues concerning CalPERS that involve "very complex and difficult questions of law."[20] In particular, "[i]f a plan is proposed that does not deal with CalPERS and if the [public bondholders] reject their treatment under the proposed plan, then [the Court] will have to focus on the question of unfair treatment."[21] Judge Klein noted that the City will have a "difficult time" confirming a plan "without being able to explain that problem away."[22] The Court, though, recognized that the evidentiary record concerning the precise nature of the relationship between the City and CalPERS was non-existent at that stage of the proceedings.[23] The Court will have to determine the nature of the relationship between the City, CalPERS and the pension beneficiaries to decide the CalPERS issue.

CalPERS disputes that it is a "creditor" in these proceedings,[24] and argues, instead, that CalPERS and the City are parties to an executory agreement that may be assumed by the City in bankruptcy. According to CalPERS, in connection with a final plan of adjustment, "the Court will consider the legal right of the City to exercise its business judgment to continue the relationship and assume the obligations to CalPERS."[25] Judge Klein previously recognized that, because § 365 is incorporated in § 901(a), the City has consented to the application of § 365 and "federal judicial interference in the form of assessing the merits of § 365 assumption or rejection of executory contracts."[26] CalPERS focuses solely on the relationship between the City and itself, not the beneficiaries, and asserts that the pension obligations are "executory in nature:

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CalPERS continues to provide benefits and the City continues to report, fund and otherwise comply with State law in connection with its participation in the system."[27] If the Court accepts CalPERS' view, the Court is likely to permit the City to assume its pension obligations as a reasonable exercise of the City's business judgment, as continued participation in the CalPERS retirement system may be necessary and beneficial to the City to attract, employ and retain quality government employees. Great deference is likely to be given to the judgment of the City in light of the 10th Amendment and §§ 903 and 904 of the Bankruptcy Code. If such obligations are permitted to be assumed, the City's obligation to fund CalPERS will not be impaired;[28] and, consequently, CalPERS would not be a "creditor" with claims subject to the prohibition against unfair discrimination of impaired classes of claims.[29]

In contrast, the Court may find that the pension obligations constitute "claims" not executory obligations subject to assumption. Judge Klein previously held that the health benefits of retiree beneficiaries are not executory obligations subject to *continued performance on both sides* because the *full service* of the retiree beneficiaries had already been provided to the City.[30] Therefore, their "asserted right to require the City to pay for health benefits based on their prebankruptcy contractual rights are 'claims'" in the bankruptcy under § 101(5).[31] If the Courts finds that CalPERS and/or the pension beneficiaries are creditors holding claims, the Court will have to determine whether non-impairment of such claims constitutes impermissible unfair discrimination against the impaired public bondholders.

Notwithstanding how the Court rules on the assumption issue, the City will have to clear an additional hurdle to confirmation—a Court determination that a plan of adjustment that substantially impairs all of the City's creditors *other than CalPERS* has been proposed in "good faith."[32]

While Judge Klein's warning to CalPERS may bring them to the negotiation table, it is far from clear that the City could be compelled to reject its CalPERS pension obligations to satisfy the requirements to confirm a plan of adjustment. It will also be interesting to see if the City changes course and seeks to reject or modify such pension obligations following the roadmap to impair vested rights set forth by Judge Klein.[33]

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[1] The author was the lead associate in the Northern Mariana Islands Retirement Fund (the "NMI Retirement Fund") bankruptcy filing seeking to modify its pension obligations to beneficiaries due to severe underfunding. The NMI Retirement Fund case was filed in Chapter 11 because the NMI Retirement Fund was not eligible for Chapter 9. The Court ultimately found that the NMI Retirement Fund was not eligible for Chapter 11 either because it was a "governmental unit" and the case was dismissed. See Memorandum of Decision on Motion to Dismiss, In re Northern Mariana Islands Retirement Fund, Case No. 12-00003 (RJF) (D. N.M.I.), filed June 13, 2012.

[2] This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to the author.

[3] In re City of Stockton, California, Case No. 12-32118-C-9 (CMK) (Bankr. E.D. Cal.).

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[4] See Transcript of Proceedings (Finding of Facts and Conclusions of Law), April 1, 2013, In re City of Stockton, California, Case No. 12-32118-C-9 (CMK) (Bankr. E.D. Cal.) (the "April 1, 2013 Bench Ruling"), at pp. 590-91.
[5] See U.S. CONST. art. I, § 10, cl. 1 ("No State shall … pass any … Law impairing the Obligations of Contracts …"); CAL. CONST. art. 1, § 9 ("A … law impairing the obligation of contracts may not be passed."); Kern v. City of Long Beach, 29 Cal.2d 848 (Cal. 1947) (holding that city was constitutionally prohibited from impairing contractually obligated vested pension rights); Betts v. Board of Administration, 21 Cal.3d 859 (Cal. 1978) (holding that State of California was constitutionally restricted from withdrawing certain vested contractual retirements benefits without the offset of "comparable new advantages").
[6] April 1, 2013 Bench Ruling, at pp. 577-78 (summarized his analysis relying on the Bankruptcy, Contracts and Supremacy Clauses of the United States Constitution as "perfectly straightforward, garden variety constitutional law"); In re City of Stockton, 478 B.R. 8, 14-16 (Bankr. E.D. Cal. 2012). Judge Klein detailed the severe fiscal problem of unrestrained pension obligations on the City's finances including "pension spiking" which permitted retirees to receive annual benefits that exceeded their annual salary earned when employed. April 1, 2013 Bench Ruling, at pp. 556-57.
[7] City of Stockton, 478 B.R. at 13.
[8] Id. at 15; see also U.S. CONST. art. I, § 8, cl. 4 ("The Congress shall have the Power … [t]o establish … uniform Laws on the subject of Bankruptcies throughout the United States.").
[9] City of Stockton, 478 B.R. at 15.
[10] Id. at 16; see also U.S. CONST. art. VI, cl. 2 ("This Constitution and the Laws of the United States … shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws to the Contrary notwithstanding.").
[11] City of Stockton, 478 B.R. at 16.
[12] Id. at 16-20.
[13] A municipality may be a chapter 9 debtor only if "specifically authorized" by State law or by a government officer or organization so empowered by State law. 11 U.S.C. §§ 109(c)(2). Thus, the State is the gatekeeper to Chapter 9 eligibility. Additionally, the municipality's consent is required as only voluntary petitions are permitted. 11 U.S.C. § 301, *incorporated by* § 901(a); see also City of Stockton, 478 B.R. at 13 (discussing the "multiple levels of consent" required).
[14] 11 U.S.C. § 941.
[15] Section 903 provides that chapter 9 "does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise… " 11 U.S.C. § 903.
[16] Section 904 provides that "[n]otwithstanding any power of the court, *unless the debtor consents* or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—

> (1) any of the political or governmental powers of the debtor;
> (2) any of the property or revenues of the debtor;
> (3) or the debtor's use or enjoyment of any income-producing property.

11 U.S.C. § 904 (emphasis added). Judge Klein referred to § 904 as the "clean-up hitter" and stated that "a federal court can use no tool in its toolkit—no inherent authority power, no implied equitable power, no Bankruptcy Code § 105 power, no writ, no stay, no order—to interfere with a municipality regarding political or governmental powers, property or revenues, or use or enjoyment of income-producing property." See City of Stockton, 478 B.R. at 20.
[17] City of Stockton, 478 B.R. at 20 ("The concern has constitutional proportions. Chapter 9 passed constitutional muster on the basis that federal power be exercised at the request of, but not at the expense of, the sovereign state in an exercise of cooperation among sovereigns."). The Court held that § 904 clearly applied under the prohibition of interfering with the debtor's "property or revenues" under § 904(2). Id. at 21.
[18] Id. at 16-17 (citing Mission Indep. School Dist. v. Texas, 116 F.2d 175, 176-78 (5th Cir. 1940) (chapter IX); In re City of Vallejo, 403 B.R. 72, 75-76 (Bankr. E.D. Cal. 2009); In re City of Stockton, 475 B.R. 720, 727-29 (Bankr. E.D. Cal. 2012); In re Cnty of Orange, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996)).
[19] Id. at 17 (citing Mission Indep. School Dist., 116 F.2d at 176-78).

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[20] April 1, 2013 Bench Ruling, at pp. 589-90.
[21] Id. at 590.
[22] Id.
[23] Id. at 587 ("If I accept the [public bondholders] … – at face value, CalPERS is just a garden variety creditor who bears the financial risk of loss, kind of as a guarantor or something. I know that CalPERS has vociferously at every stage of this proceeding contested that kind of assertions. And it is no secret that the [public bondholders] have CalPERS in the crosshairs for a dispute over that.").
[24] See e.g., CalPERS' Brief in Support of the City of Stockton's Petition, Feb. 15, 2013, In re City of Stockton, California, Case No. 12-32118-C-9 (CMK) (Bankr. E.D. Cal.) (the "CalPERS' Brief"), at pp. 2-3 ("The [public bondholders] also misconstrue the nature of the financial obligations that the City owes to CalPERS. So long as the City continues to participate in the system, it does not owe CalPERS unfunded liability amounts or termination obligations in the millions or billions of dollars. To that extent, it is inaccurate to state that CalPERS is presently the largest creditor of the City. The City has a continuing obligation to fund its payments to CalPERS as determined by CalPERS' actuaries. The City is in good standing with CalPERS and is current on its payments to the system. Accordingly, there is no debt to CalPERS that will be adjusted in the City's plan.")
[25] Id. at p. 3.
[26] City of Stockton, 478 B.R. at 21-22. In City of Vallejo, the court held that state labor law could not provide the applicable standard controlling the rejection of the City's collective bargaining agreements because § 365 and the Bankruptcy Code preempt conflicting state law. 403 B.R. at 77.
[27] Calpers' Brief, at p. 2.
[28] 11 U.S.C. §§ 365(a)-(b) (contractual obligations must be assumed according to their terms absent consent for modification and any defaults must be cured).
[29] 11 U.S.C. §§ 1129(b)(1) *incorporated by* § 901(a) (requiring for confirmation that "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.")
[30] City of Stockton, 478 B.R. at 22, 24-25, 27.
[31] Id.
[32] 11 U.S.C. § 1129(a)(3), *incorporated by* § 901(a).
[33] Rejection of the pension obligations likely would require the Court to find satisfaction of a more stringent standard than reasonable business judgment. Although §§ 1113 and 1114 do not apply in Chapter 9 proceedings, the bankruptcy court in City of Vallejo required the municipality to satisfy the standards set forth in NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984) to reject a collective bargaining agreement, which required the municipality to demonstrate that (1) the collective bargaining agreement burdens the estate; (2) after careful scrutiny, the equities balance in favor of contract rejection; and (3) reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution. 403 B.R. at 77-78.

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