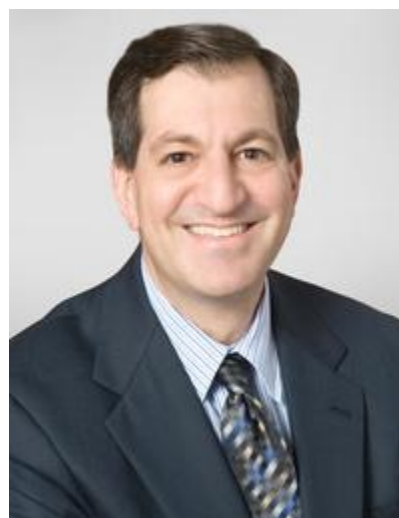


## A New Playing Field For Distressed Municipalities

*Law360, New York (November 14, 2014, 10:24 AM ET) --*

The perception that public employee pension obligations cannot be impaired in bankruptcy suffered a damaging blow nearly one year ago in the city of Detroit bankruptcy case, and has now been fatally wounded by the recent ruling of Judge Christopher Klein in the Chapter 9 case of Stockton, California.

Although Judge Klein's decision is not likely to lead to a spate of municipal bankruptcy filings in an effort to escape burdensome pension liabilities (indeed, it did not even lead to the actual diminishment of pension claims in the Stockton case itself), this is an important decision, and will alter the legal landscape for distressed municipalities. Together with the similar Detroit decision, the Stockton ruling will affect negotiations among municipalities, employee unions, pension system representatives and financial creditors across the country.



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Issues regarding the appropriate legal treatment of public employee pension obligations, and the 10th Amendment implications in connection therewith, have been a crucial overhang for distressed municipalities and in Chapter 9 municipal bankruptcy cases for several years. The 10th Amendment of the U.S. Constitution reserves to a state rights not granted to the federal government. The key question has been whether state laws protecting public employee pension obligations are protected under the 10th Amendment, or are preempted and superseded by Congress' Article I, Section 8 authority to establish uniform laws regarding bankruptcy.

In Stockton, the city proposed a plan that recognizes California's pension protections and that would not impair those obligations, while at the same time substantially reducing the claim of Franklin Investments, a major city bondholder. Under the U.S. Bankruptcy Code, plans of adjustment for municipal debtors, similar to plans of reorganization for corporate debtors, prohibit "unfair" discrimination among classes of similarly situated creditors.

The city of Stockton and the California public employee pension system (Calpers) contended that the disparity between Franklin's claims and Calpers' claims is permissible, because the preference under California law for public employee pension obligations is protected under the 10th Amendment. Franklin objected to the plan, claiming that the disparate treatment is impermissible, because California law

regarding public employee pension obligations is preempted by the supremacy clause of the Constitution and subject to Congress' bankruptcy power.

Judge Klein made his ruling on Stockton's plan in two parts. In early October, he first addressed the specific argument between Franklin and Calpers. Judge Klein agreed with Franklin: on this issue, the supremacy clause overrides state law. There is no abrogation of the 10th Amendment because the state of California has expressly authorized municipalities to seek protection under Chapter 9.

In Judge Klein's view, when the California Legislature enacted the authorization law, it "open[ed] the gate" and was approving a process that it knew would be governed by federal law. "Once the city passes through the gate, it's what's specified in the United States Bankruptcy Code. Otherwise, you come to the conclusion that the California Legislature can edit ... federal law."

In his final ruling on Oct. 30, however, Judge Klein approved the Stockton plan. He held that sufficient differences exist between the nature of public pension obligations and the debt evidenced by the city's bonds to justify the disparate treatment. He found that the city had proposed the plan in good faith, that it was feasible, and overall in the best interests of the city's creditors, and accepted the city's judgment that maintaining the pension obligations was necessary in order not to lose key employees.

He also noted that city employees were being affected in other ways, as the plan eliminated retiree medical benefits and certain cost-of-living adjustments. Aware that a contrary decision could put the parties back to "square one" and lead to months if not years of additional litigation at a cost of millions of dollars, Judge Klein concluded that the plan "is the best that can be done in terms of the restructuring and adjustments of the debts of the city of Stockton."

The impact of Judge Klein's first ruling nevertheless should not be disregarded. Up until now, many practitioners and legal scholars have believed that state law preferential treatment for public pension obligations would be insulated in Chapter 9 bankruptcy cases. Moreover, although Judge Stephen Rhodes issued a similar decision last year in the Detroit bankruptcy case, that ruling was more limited, as it relied on a detailed parsing of Michigan statutes and the Michigan Constitution.

In Stockton, Judge Klein made a broad ruling that federal law controls. His decision will provide leverage to parties that wish to impair pension obligations. For municipalities that wished to impair their pension obligations, there has been nothing but uncertainty as to whether a Chapter 9 bankruptcy proceeding could succeed. That uncertainty has now been effectively eliminated. But at the same time, because Chapter 9 is such an onerous and expensive process, it is unlikely that there will be a rush of municipalities into the bankruptcy courts.

The Detroit plan of adjustment approved last week by Judge Rhodes perhaps provides an example of what the future holds for distressed municipalities that wish to use Chapter 9 to reduce pension obligations. The Detroit plan, following Judge Rhode's earlier ruling, does impair pension claims. But it was a consensual plan, the result of extraordinary efforts and creative thinking among lawyers and advisers for the city, the state of Michigan, unions, pension fund representatives, and financial creditors.

The Detroit plan centered on a so-called "Grand Bargain" that raised hundreds of millions in donations to insulate masterworks of art at the Detroit Institute of Art from a possible sale. These funds were then utilized to shore up Detroit's pension system in order to minimize the reduction in pension payments. Detroit also found creative ways to reach settlements with financial creditors who believed, similar to Franklin, that the treatment of their claims constituted unfair discrimination.

With luck, the new playing field resulting from the Stockton and Detroit cases will lead public pension advocates, financial creditors and distressed municipalities away from unyielding positions. The takeaway from the final outcomes of both Stockton and Detroit is that while public employee pensions are no longer sacrosanct and can be impaired, it will in each instance require a lengthy, expensive and determined effort.

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