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Modifying or Terminating Pension Plans Through Chapter 9 Bankruptcies with a Focus on California

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MODIFYING OR TERMINATING PENSION PLANS THROUGH CHAPTER 9 BANKRUPTCIES WITH A FOCUS ON CALIFORNIA

*Joanne Lau**

Introduction	1976
I. An Overview of Chapter 9 and Pensions in Chapter 11	
Generally	1979
A. Chapter 9 Bankruptcy Generally	1980
B. Treatment of Pensions in Chapter 11 Bankruptcy	1984
C. Added Complications of Chapter 9	1988
D. California as the Focus	1989
II. Federal Law v. State Law and the Nature of Pension Plans	1990
A. Federalism Issues in Chapter 9: Where State and Federal Powers Conflict	1990
B. Various State Law Perspectives on the Nature of Pension Plans and Their Ability to be Modified in Bankruptcy	1992
C. Whether a Pension Plan is an Executory Contract: The Countryman Test.....	1995
D. Rejection as a Prepetition Breach of Contract	1999
E. Federalism Issues Regarding Treatment of the Pension Plan as a Prepetition Breach of Contract Claim.....	1999
1. Treatment Under California State Labor Law	2000
2. Treatment Under Federal Bankruptcy Law	2003
III. Pension Plans May Be Rejected as Executory Contracts	2007
Conclusion.....	2009

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INTRODUCTION

When Stockton, California, a city of just under 300,000 people, filed for Chapter 9 protection on June 28, 2012,¹ it became the largest U.S. city by population to do so.² Like other municipalities, Stockton has been greatly affected by the collapse of the sub-prime lending market from 2007 to 2008.³ Stockton, however, was disproportionately affected because of its location in the Central Valley region of California, an attractive location for those who want to live near the Bay area, with one out of every thirty homes in foreclosure.⁴ The high foreclosure rate, coupled with declining home values, has decreased Stockton's tax revenue from property taxes.⁵ Because of this decrease in tax revenue, the city has had difficulties repaying obligations to creditors as they become due.⁶ In order to meet its obligations, Stockton has been forced to cut the services it provides to citizens to the bare minimum required to maintain the city.⁷ Although Stockton has been ranked as the second most dangerous city in California, second only to Oakland, and one of the ten most dangerous cities in America, it has had to slash its police force by twenty-five percent to cut costs.⁸ Stockton was also named

1. Chapter 9 Voluntary Petition at 1, *In re City of Stockton, Cal.*, No. 12-32118 (Bankr. E.D. Cal. June 28, 2012), ECF No. 1.

2. See Nate Berg, *The 7 Biggest Cities Ever to File for Bankruptcy*, ATLANTIC CITIES (June 27, 2012), <http://www.theatlanticcities.com/jobs-and-economy/2012/06/7-biggest-cities-file-bankruptcy/2397/>; *Stockton (City), California*, U.S. CENSUS BUREAU, <http://quickfacts.census.gov/qfd/states/06/0675000.html> (last updated June 27, 2013). Detroit, Michigan filed for Chapter 9 protection on July 18, 2013, supplanting Stockton as the largest city by population to file for bankruptcy. Monica Davey & Mary Williams Walsh, *Billions in Debt, Detroit Tumbles Into Insolvency*, N.Y. TIMES (July 18, 2013), http://www.nytimes.com/2013/07/19/us/detroit-files-for-bankruptcy.html?hp&_r=0.

3. See generally FED. RESERVE BANK OF S.F., THE SUBPRIME MORTGAGE MARKET: NATIONAL AND TWELFTH DISTRICT DEVELOPMENTS (2007), available at <http://www.frbsf.org/files/2007annualreport.pdf>.

4. Les Christie, *California Cities Fill Top 10 Foreclosure List*, CNN MONEY (Aug. 14, 2007), http://money.cnn.com/2007/08/14/real_estate/California_cities_lead_foreclosure/index.htm.

5. *Id.*

6. *Id.*

7. Malia Wollan, *Years of Unraveling, Then Bankruptcy for a City*, N.Y. TIMES, July 18, 2012, http://www.nytimes.com/2012/07/19/us/years-of-unraveling-then-bankruptcy-for-a-city.html?pagewanted=all&_r=0.

8. *Id.*; *America's 10 Most Dangerous Cities*, CBS NEWS, http://www.cbsnews.com/2300-504083_162-10007941.html (last visited Oct. 25, 2013).

2013]

MODIFYING PENSION PLANS

1977

America's most miserable city by Forbes in 2011.⁹ Citizens who are able to leave the city are doing so as a result, sending Stockton into a downward spiral with even more decreases in revenue from property taxes.¹⁰ After rounds of failed negotiations with creditors, required by Section 53760 of the California Government Code, Stockton filed for Chapter 9 protection to solve its fiscal crisis.¹¹ The California Public Employees' Retirement System (CalPERS), a state executive agency that manages pension and health benefits for California's public employees, retirees, and their families,¹² is Stockton's largest creditor, with a contingent, unliquidated claim of over \$147 million.¹³ This obligation is an obstacle to a city that is trying to provide for its citizens, meet other debt obligations, and maintain some form of credit in order to borrow in the future.

The story of Stockton is not unlike that of many other U.S. cities. Municipalities have mounting obligations as a result of providing services, building infrastructure, paying payroll, and contributing to benefits for city employees.¹⁴ The economic recession and collapse of real estate values reduced the tax base and tax revenues generated at the local level with lower property values translating to decreased property taxes.¹⁵ The result is a lower municipal income and tighter budget constraints.¹⁶ The high foreclosure rate reduces the value of the property foreclosed upon and that of surrounding properties. There is also less federal funding to states, which means less state funding for municipalities. Some municipalities operate on short-term financing, borrowing money in the form of bonds in order to pay for current obligations.¹⁷ These municipalities need to continuously

9. Kurt Badenhausen, *America's Most Miserable Cities*, FORBES (Feb. 2, 2011), <http://www.forbes.com/2011/02/02/stockton-miami-cleveland-business-washington-miserable-cities.html>.

10. Wollan, *supra* note 7.

11. CAL. GOV'T CODE §§ 53760, 53760.3 (West 2012).

12. CAL. PUB. EMPLOYEES' RETIREMENT SYS., FACTS AT A GLANCE (2012), available at <http://www.calpers.ca.gov/eip-docs/about/facts/general.pdf>.

13. List of Creditors Holding 20 Largest Unsecured Claims at 1, *In re City of Stockton, Cal.*, No. 12-32118 (Bankr. E.D. Cal. June 28, 2012), ECF No. 4.

14. See generally Will Hueske, *Chapter 9 Update: Alabama Municipalities Eligible as "Debtors" Under 109(c)*, WEIL BANKR. BLOG (May 22, 2012), <http://business-finance-restructuring.weil.com/chapter-9/chapter-9-update-alabama-municipalities-eligible-as-debtors-under-section-109c>.

15. *Id.*

16. See *id.*

17. See Michael Corkery & Ianthe Jeanne Dugan, *New Hit to Strapped States—Borrowing Costs Up as Bond Flops; Refinancing Crunch Nears*, WALL ST. J., Jan. 14,

borrow money in order to meet those obligations.¹⁸ When credit froze, these municipalities defaulted on their obligations, which in turn caused additional cross-defaults on other credit obligations.¹⁹

Public pension plan obligations are an increasing problem for municipalities with large deficits.²⁰ Public employees are promised more in their retirement plans than the municipalities can afford to pay.²¹ Pension plans have been underfunded in the last couple of years because estimated rates of return on pension plan investments have been significantly higher than actual returns.²² Municipalities typically promise public employees defined-benefit plans, where employees are promised certain specific benefits upon retirement.²³ The Government Accounting Standards Board (GASB) has provided general standards for accounting and financial reporting that most state and local government plans follow.²⁴ However, median investment return for public pension funds was negative 24.91% in 2008.²⁵ The aggregate market value of state and local government pension funds dropped from \$3.2 trillion in 2006 to just \$2.3 trillion as of October 31, 2008.²⁶ This chronic underfunding, coupled with demographic pressures like increased life expectancies and pension envy, where public sector employees generally expect larger pensions than their private sector counterparts, has contributed to the mounting pension obligations of many municipalities.

2011, at A1 (reporting on the elevated rates municipalities are being forced to pay to issue debt).

18. *See generally id.*

19. Hueske, *supra* note 14.

20. *See* Jeffrey Ellman & Daniel Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 EMORY BANKR. DEV. J. 365, 368–69 (2011).

21. *See id.* at 368.

22. *Id.* at 369.

23. *See id.* at 374.

24. *See generally* GOV'T ACCT. STANDARDS BD., SUMMARY OF STATEMENT NO. 25: FINANCIAL REPORTING FOR DEFINED BENEFIT PENSION PLANS AND NOTE DISCLOSURES FOR DEFINED CONTRIBUTION PLANS (1994), *available at* <http://www.gasb.org/st/summary/gstsm25.html>; GOV'T ACCT. STANDARDS BD., SUMMARY OF STATEMENT NO. 27: ACCOUNTING FOR PENSIONS BY STATE AND LOCAL GOVERNMENT EMPLOYEES (1994), *available at* <http://www.gasb.org/st/summary/gstsm27.html>.

25. STANDARD & POOR'S RATINGS DIRECT, STANDARD & POOR'S, MARKET DECLINES WILL SHAKE UP U.S. STATE PENSION FUND STABILITY 2 (2009).

26. Jonathan Barry Forman, *Funding Public Pension Plans*, 42 J. MARSHALL L. REV. 837, 850–51 (2009).

2013]

MODIFYING PENSION PLANS

1979

Part I of this Note provides background information on Chapter 9²⁷ of the Bankruptcy Code, treatment of private sector pension plans under Chapter 11, and the differences between Chapter 9 and Chapter 11 as they relate to pension obligations. This Note then examines the conflicts presented by various state law perspectives on the nature of pension plans and their ability to be modified, whether a pension plan is an executory contract, and federalism issues regarding treatment of prepetition breach of contract claims. This Note then argues that in jurisdictions such as California, where public employees' rights under pension plans are viewed as contractual rights, pension plans may be rejected as executory contracts, pursuant to § 365,²⁸ as applied at a Chapter 9 municipal reorganization proceeding. The extent to which rejection amounts to a modification of pension plan obligations will depend upon the extent to which these obligations have "vested" under federal law. Thus, municipalities may use the tools available in bankruptcy to reorganize debt and better provide for their constituencies going forward.

I. AN OVERVIEW OF CHAPTER 9 AND PENSIONS IN CHAPTER 11 GENERALLY

Since Chapter 9 bankruptcies are so rare, there is little case law on treatment of pensions in Chapter 9. Chapter 9, a reorganization chapter, adopts many of the provisions available in a chapter 11 bankruptcy, also a reorganization chapter of the Bankruptcy Code.²⁹ As such, an analysis of treatment of pensions in chapter 11 is necessary to analogize what may happen in chapter 9 bankruptcies, taking into account the differences between the two chapters. Here, this Note discusses Chapter 9 bankruptcies generally, how pensions are treated in Chapter 11 bankruptcies, what makes treatment of pensions in Chapter 9 more complicated than treatment of pensions in Chapter 11 bankruptcies, and why California is the focus of this Note.

27. In this Note, whenever a chapter is listed, it refers to a chapter in the Bankruptcy Code.

28. In this Note, whenever a section is listed, it refers to 11 U.S.C., the Bankruptcy Code.

29. See 11 U.S.C. § 901 (2012) (listing sections of the Bankruptcy Code that apply to Chapter 9 bankruptcies and including provisions of Chapter 11).

A. Chapter 9 Bankruptcy Generally

Chapter 9 of the Bankruptcy Code allows municipalities to reorganize their debts.³⁰ It provides municipalities in financial-distress protection from creditors while it develops and negotiates a plan for readjusting its debts. This reorganization typically involves extending debt maturities, reducing the principal or interest rates of loans, and refinancing existing debt.³¹

Chapter 9 is different from other chapters of the Bankruptcy Code, in that some provisions of the Bankruptcy Code do not apply.³² Only those sections listed in § 901 apply to Chapter 9 bankruptcies, while all provisions of Chapters 1, 3, and 5 apply to bankruptcies under Chapters 7, 11, 12, and 13 of the Bankruptcy Code.³³ In the context of pension modification, Chapter 11 reorganizations have specific provisions that govern rejection of collective bargaining agreements and treatment of retiree health benefits.³⁴ Sections 1113 and 1114, which discuss collective bargaining agreements and retiree health benefits, respectively, might otherwise govern in a Chapter 9 reorganization, but neither is listed as an applicable provision under § 901.³⁵ Section 362, however, does apply to Chapter 9 bankruptcies, giving municipalities the benefit of the automatic stay while it

30. *See generally* 11 U.S.C. §§ 901–46 (2012).

31. *See, e.g.*, Chapter 9 Plan Fourth Amended Plan for the Adjustment of Debts Filed by Debtor The City of Central Falls, Rhode Island, *In re* City of Central Falls, R.I., No. 11-13105 (Bankr. D.R.I. Aug. 1, 2011), ECF No. 479.

32. *See* 11 U.S.C. § 901 (specifically listing provisions of the Bankruptcy Code that apply and omitting those that do not).

33. 11 U.S.C. § 901 provides, in relevant part:

(a) Sections 301, 333, 344, 347(b), 349, 350(b)[,] 351[,], 361, 362, 364(c), 364(d), 364(e), 364(f), 365, 366, 501, 502, 503, 504, 506, 507(a)(2), 509, 510, 524(a)(1), 524(a)(2), 544, 545, 546, 547, 548, 549(a), 549(c), 549(d), 550, 551, 552, 553, 555, 556, 557, 559, 560, 561, 562, 1102, 1103, 1109, 1111(b), 1122, 1123(a)(1), 1123(a)(2), 1123(a)(3), 1123(a)(4), 1123(a)(5), 1123(b), 1123(d), 1124, 1125, 1126(a), 1126(b), 1126(c), 1126(e), 1126(f), 1126(g), 1127(d), 1128, 1129(a)(2), 1129(a)(3), 1129(a)(6), 1129(a)(8), 1129(a)(10), 1129(b)(1), 1129(b)(2)(A), 1129(b)(2)(B), 1142(b), 1143, 1144, and 1145 of this title apply in a case under this chapter.

Id.

34. *See* 11 U.S.C. §§ 1113, 1114 (2012).

35. *See* 11 U.S.C. § 901 (2012) (not listing §§ 1113 and 1114 as applicable sections under Chapter 9).

2013]

MODIFYING PENSION PLANS

1981

attempts to negotiate with creditors.³⁶ Section 365 also applies, which allows the debtor to assume or reject executory contracts.³⁷

There are two significant sources of limitations in Chapter 9 that differentiate Chapter 9 from other sections of the Bankruptcy Code: a municipality cannot liquidate and dissolve in bankruptcy, and there are constitutional limits of the bankruptcy court's power.³⁸ Giving the Bankruptcy Court the power to approve and manage a liquidation and dissolution would be a violation of the Tenth Amendment's protection to states of sovereignty over their internal affairs.³⁹ States can dictate whether their municipalities seek Chapter 9 bankruptcy protection.⁴⁰ An unauthorized municipality is ineligible for relief.⁴¹ It is through the requirement of state authorization that Chapter 9 satisfies the requirements of federalism. Through these means, the federal government's interests in financially sound municipalities are balanced against states' sovereign authority over its municipalities.

Section 109 governs eligibility for Chapter 9.⁴² Under § 109, an entity must be (1) a municipality, (2) authorized by statute by the state where the municipality is located, (3) that is insolvent and (4) desires to affect a plan to adjust such debts, and (5) (A) has obtained the agreement of impaired classes of creditors; (B) has failed to obtain the agreement of impaired classes of creditors after good faith negotiations; (C) cannot negotiate with creditors because such negotiation is impracticable; or (D) believes that a creditor may attempt to obtain a transfer that is avoidable under § 547.⁴³ The second requirement under § 109, that a state statute specifically authorizes the municipality to enter Chapter 9, allows states to act as gatekeepers as to whether and which municipalities can file for Chapter 9 protection.⁴⁴ States vary in their approach to this

36. *Id.* Section 362 is listed under § 901 as a provision that applies in Chapter 9. Section 362 governs the automatic stay. 11 U.S.C. § 362 (2012).

37. 11 U.S.C. § 901 (2012). Section 365 is listed under § 901 as a provision that applies in chapter 9. Section 365 governs the executory contracts. 11 U.S.C. § 365 (2012).

38. *See* Lee Bogdanoff, *Understanding Chapter 9 in Today's Economic Environment*, in CHAPTER 9 BANKRUPTCY STRATEGIES 49 (Jo Alice Darden ed., 2011) (noting that the bankruptcy court cannot convert a Chapter 9 case into a Chapter 7 liquidation case).

39. *See* U.S. CONST. amend. X.

40. 11 U.S.C. § 109 (2012).

41. *See id.*

42. *Id.*

43. *Id.*

44. *In re* City of Vallejo, Cal. 403 B.R. 72, 76 (Bankr. E.D. Cal. 2009).

provision.⁴⁵ Some states preclude access to Chapter 9 for all municipalities within their jurisdiction; others broadly permit access to Chapter 9.⁴⁶ Twenty-three states do not provide access to Chapter 9.⁴⁷ Of these twenty-three states, twenty-one do not have statutes allowing municipalities in the state to file for Chapter 9 protection, while Georgia and Iowa explicitly deny access to Chapter 9 by statute.⁴⁸ Some states condition eligibility, providing that only those municipalities meeting specified requirements can file for bankruptcy

45. Transcript of Proceedings (Findings of Fact and Conclusions of Law) (Trial Volume IV) at 575, *In re City of Stockton, Cal.*, No. 12-32118 (Bankr. E.D. Cal. June 28, 2012), ECF No. 898.

46. *Id.* (“Now, that raises a number of possibilities in various states around the country in their gatekeeping function, and this is what gives the states the power to control whether Chapter 9 cases are filed, have a number of alternatives. For example, in the State of Rhode Island, which recently went through the case of Central Falls, Rhode Island, the state-mandated procedure was that there was a receiver in charge of the city that came in, had the authority to throw out the city council, the mayor, run the city, and have all the deals that could be made. And that receiver had authority to file a Chapter 9 case if the receiver concluded that Chapter 9 was necessary for him to accomplish his mission, and that’s what happened. So that’s an example of somebody empowered by state law to authorize an entity to file.”).

47. CORY EUCALITTO ET AL., STATE BUDGET SOLUTIONS, MUNICIPAL BANKRUPTCY: AN OVERVIEW FOR LOCAL OFFICIALS 7 (2013), available at http://www.statebudgetsolutions.org/doclib/20130301_SBSBankruptcyReport.pdf (showing Alaska, Delaware, Hawaii, Indiana, Kansas, Maine, Maryland, Massachusetts, Mississippi, Nevada, New Hampshire, New Mexico, North Dakota, South Dakota, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin, and Wyoming as the twenty-one states without such statutes).

48. *Id.* Georgia law provides:

(a) No county, municipality, school district, authority, division, instrumentality, political subdivision, or public body corporate created under the Constitution or laws of this state shall be authorized to file a petition for relief from payment of its debts as they mature or a petition for composition of its debts under any federal statute providing for such relief or composition or otherwise to take advantage of any federal statute providing for the adjustment of debts of political subdivisions and public agencies and instrumentalities.

(b) No chief executive, mayor, board of commissioners, city council, board of trustees, or other governmental officer, governing body, or organization shall be empowered to cause or authorize the filing by or on behalf of any county, municipality, school district, authority, division, instrumentality, political subdivision, or public body corporate created under the Constitution or laws of this state of any petition for relief from payment of its debts as they mature or a petition for composition of its debts under any federal statute providing for such relief or composition or otherwise to take advantage of any federal statute providing for the adjustment of debts of political subdivisions and public agencies and instrumentalities.

GA. CODE ANN. § 36-80-5 (2012).

2013]

MODIFYING PENSION PLANS

1983

protection.⁴⁹ Some states specifically authorize municipalities to file for Chapter 9 bankruptcy protection with no condition, but California allows for broad, blanket authorization as long as one listed condition applies.⁵⁰ California is one of these states providing broad municipal access to Chapter 9.⁵¹

The bankruptcy court's power under Chapter 9 is more limited than in a Chapter 11 bankruptcy.⁵² The bankruptcy court is less involved in the conduct and operation of the municipality in bankruptcy, while a debtor-in-possession in a Chapter 11 reorganization fully submits itself to bankruptcy court jurisdiction.⁵³ Section 904 explicitly provides that a bankruptcy court may not interfere with a municipality's governmental powers, the property or revenue of the debtor, or the debtor's use of income-producing property.⁵⁴ A court also may not appoint a trustee or receiver to oversee the affairs of the debtor in bankruptcy.⁵⁵ In a Chapter 9 case,

49. For example, Pennsylvania prohibits Third-Class cities (population under 250,000 and not classified as Second Class A) from filing. *In re City of Harrisburg*, Pa., 465 B.R. 744, 752–53 (Bankr. M.D. Pa. 2011) (applying 72 PA. CONS. STAT. § 1601-D.1 (2013)); *see* 53 PA. CONS. STAT. § 101 (outlining requirements for classification as Second Class A). First-Class cities may file with the Governor's approval. 53 PA. CONS. STAT. § 12720.211. Second-Class cities may file with Governor's approval. 53 PA. CONS. STAT. § 28211. In Alabama, a municipality must have bond debt in order to be eligible for Chapter 9. *In re Jefferson Cnty.* Ala., 469 B.R. 92, 98 (Bankr. N.D. Ala. 2012) (applying ALA. CODE 11-81-3 (LexisNexis 2008)).

50. EUCALITTO ET AL., *supra* note 47, at 7.

51. *See* CAL. GOV'T CODE § 53760 (West 2013). Section 53760 provides:

A local public entity in this state may file a petition and exercise powers pursuant to applicable federal bankruptcy law if either of the following apply: (a) The local public entity has participated in a neutral evaluation process pursuant to Section 53760.3[;] (b) The local public entity declares a fiscal emergency and adopts a resolution by a majority vote of the governing board pursuant to Section 53760.5.

Id.

52. *See generally* DEBT ADJUSTMENTS FOR MUNICIPALITIES UNDER CHAPTER 9 OF THE BANKRUPTCY CODE §7[1] (Francis J. Lawall et al. eds., 2012).

53. *See generally id.*

54. 11 U.S.C. § 904 (2012) Section 904 provides:

Notwithstanding 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; or (3) the debtor's use or enjoyment of any income-producing property.

Id.

55. *See* 11 U.S.C. § 901(a) (not incorporating § 1104 (appointment of a trustee) into Chapter 9); *see also* Spellings v. Dewey, 122 F.2d 652 (8th Cir. 1941) (bankruptcy court could not interfere in any manner with right of Arkansas drainage district

a bankruptcy court's power is limited to approving the petition, confirming the plan, and ensuring that plan obligations are met.⁵⁶ A municipality in bankruptcy may manage itself while taking advantage of the Bankruptcy Code's provisions.⁵⁷ *In re Willacy County Water Control & Improvement District No. 1* makes clear that the bankruptcy court can only

determine insolvency or inability to meet debts as they mature, and whether the plan proposed is in accordance with the provisions of the statute, and whether it has been accepted by the number of creditors provided, and whether the petitioner is in a position to carry out the terms of the plan, and whether it is equitable, for the best interests of the creditors, and nondiscriminatory.⁵⁸

The court can only confirm the plan or dismiss the case based on its answers to these questions.⁵⁹ As such, much of the litigation surrounding Chapter 9 cases involves the municipal debtor's eligibility to seek Chapter 9 protection.⁶⁰ The practical and constitutional limitations of Chapter 9 and differences between Chapter 9 and other chapters of the Code lead to limited Chapter 9 filings.

B. Treatment of Pensions in Chapter 11 Bankruptcy

A pension plan is a scheme created by employers or an agency to provide income for employees when they retire.⁶¹ There are generally two types of pension plans: defined contribution plans and defined benefit plans.⁶² In a defined contribution plan, the employer and

under Arkansas statutes to choose or remove its commissioners); *In re N.Y.C. Off-Track Betting Corp.*, 434 B.R. 131 (Bankr. S.D.N.Y. 2010) (where New York law was, at best, ambiguous regarding when off-track betting commissions must be paid postpetition, preferable course was for the Chapter 9 bankruptcy court to abstain under 28 U.S.C. § 1334(c), as political or governmental powers of debtor could not be limited by court under § 904).

56. *See supra* notes 54–55 and accompanying text.

57. *See supra* notes 54–55 and accompanying text.

58. *In re Willacy Cnty. Water Control & Improvement Dist. No. 1*, 36 F. Supp. 36, 39 (S.D. Tex. 1940).

59. *Id.*

60. *See, e.g.*, National Public Finance Guaranty Corporation's Objection to the City of Stockton's Qualifications Under Sections 109(c) and 921(c) at 1–10, *In re Stockton, Cal.*, No. 12-32118 (E.D. Cal. June 28, 2012), ECF No. 477 (seeking dismissal of Stockton's Chapter 9 case because of Stockton's alleged failure to meet the requirements stated in 109(c)).

61. *See Retirement Plans, Benefits & Savings*, U.S. DEP'T LABOR, <http://www.dol.gov/dol/topic/retirement/typesofplans.htm> (last visited Oct. 25, 2013).

62. *Id.*

2013]

MODIFYING PENSION PLANS

1985

employee may make contributions to the plan fund, “the employer’s contribution is fixed[,] and the employee receives whatever level of benefits the amount contributed on his behalf will provide.”⁶³ “A defined contribution plan ‘provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant’s account.’”⁶⁴ Since each individual in a defined contribution pension plan is only entitled to payouts from the assets dedicated to the individual account, there cannot be a deficiency of funds in the plan to cover promised benefits.⁶⁵ The United States Code specifies that any pension plan that is not a defined contribution plan is a defined benefit plan.⁶⁶ A defined benefit plan “consists of a general pool of assets rather than individual dedicated accounts. Such a plan, ‘as its name implies, is one where the employee, upon retirement, is entitled to a fixed periodic payment.’”⁶⁷ In a defined benefit plan, the asset pool may be funded by the employer, the employee, or both.⁶⁸ Although the employee may also make contributions to the asset pool, the employer typically bears all of the investment risk and usually bears any loss resulting from any investment shortfall.⁶⁹ On the other hand, if a defined benefit fund is overfunded, the employer is permitted to reduce or suspend contributions.⁷⁰

Only defined benefit pension systems are affected in bankruptcy because defined contribution pension systems are presumed to be fully funded. Each individual in a defined contribution pension plan is only entitled to payouts from the assets dedicated to the individual account.⁷¹ Defined benefit pension systems can either be funded or

63. *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 439 (1999) (quoting *Nachman Corp. v. Pension Benefit Guar. Corp.*, 446 U.S. 359, 364 n.5 (1980)).

64. *Id.* (quoting 29 U.S.C. § 1002(34) (2006)).

65. *Nachman Corp.*, 444 U.S. at 364 n.5.

66. 26 U.S.C. § 414(j) (2006).

67. *Hughes Aircraft Co.*, 525 U.S. at 439 (quoting *Comm’r v. Keystone Consol. Indus.*, 508 U.S. 152, 154 (1993)).

68. *Id.* (citing 29 U.S.C. § 1054(c) (2006)).

69. *See id.* (quoting *Connolly v. Pension Benefit Guar. Corp.*, 475 U.S. 211, 232 (1986) (O’Connor, J., concurring); JEFFREY D. MAMORSKY, *EMPLOYEE BENEFITS LAW* § 8:4 (1998)).

70. *See Nachman*, 444 U.S. at 363–64 n.5 (noting that “the employer’s contribution is adjusted to whatever level is necessary” to provide the defined benefits (internal quotation marks omitted)).

71. *Id.*

unfunded.⁷² A funded plan means the employer is contributing assets that are invested.⁷³ However, even some funded defined benefit pension systems are underfunded as a result of overly ambitious assumptions on investment returns and failure to fund pension plans when the employer is strapped for cash.⁷⁴ An unfunded pension plan means that no assets are set aside and benefits are paid for by the employer to the retiree as and when they are paid.⁷⁵ This plan is commonly referred to as a “pay-as-you-go” system.⁷⁶ Funded and unfunded plans are both affected in bankruptcy because funded plans can be underfunded and unfunded plans are a problem when the employer simply does not have the money to meet obligations.⁷⁷ However, Chapter 11 only deals with underfunded plans⁷⁸ because the Employee Retirement Income Security Act (ERISA) prohibits unfunded, or pay-as-you-go plans.⁷⁹ Both unfunded and underfunded plans are at issue in Chapter 9.

Chapter 11 also distinguishes between vested and unvested pension plans. This distinction typically is governed by federal law, dictating when the pension plan vests, if at all. This distinction is, however, informed by state law. To be vested means that the employee has a right to the pension plan that cannot be decreased.⁸⁰ If plans are unvested, the employee does not yet have a right to the benefits.⁸¹ The pension plan may be modified by the employer in bankruptcy until the plan vests under federal law.⁸² Outside of bankruptcy, the question of when the pension plan vests and whether and to what extent it can be modified is determined by state law.

72. See *What You Should Know About Your Retirement Plan: Chapter 2*, U.S. DEP'T LABOR, <http://www.dol.gov/ebsa/publications/wyskapr.html#chapter2> (last visited Oct. 25, 2013).

73. See *id.*

74. See COURTNEY COLLINS & ANDREW J. RETTENMAIER, NAT'L CTR. FOR POLICY ANALYSIS, UNFUNDED LIABILITIES OF STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT BENEFIT PLANS 13 (2010), available at <http://www.ncpa.org/pdfs/st329.pdf>.

75. See generally *id.*

76. *Id.* at 11.

77. See generally *id.*

78. 11 U.S.C. § 1121 (2012).

79. See generally 29 U.S.C. §§ 1001–1461 (2006). ERISA sets minimum standards for funding and unfunded plans would not meet ERISA standards. See generally *id.*

80. See *In re UAL Corp. (Pilots' Pension Plan Termination)*, 468 F.3d 444, 447 (7th Cir. 2006); *In re Alan Wood Steel Co.*, No. 77-930 1978 U.S. Dist. LEXIS 20428, at *2 (Bankr. E.D. Pa. Dec. 29, 1978).

81. See 70 C.J.S. *Pensions* § 119 (2005).

82. See *In re Bastian Co.*, 45 B.R. 717, 720 (Bankr. W.D.N.Y. 1985).

2013]

MODIFYING PENSION PLANS

1987

Private sector defined benefit pension plans can be modified or terminated in a Chapter 11 bankruptcy, but not solely as a matter of federal bankruptcy law.⁸³ ERISA, the statute governing private sector defined-benefit pension plans, specifically provides for termination of Pension Benefit Guaranty Corporation (PBGC)-insured plans both in and out of bankruptcy.⁸⁴ The prerequisites for termination of PBGC-insured plans are listed in 29 U.S.C. § 1341(c)(2)(B).⁸⁵ In *In re Wire Rope Corp. of America*, the court determined that the debtor “cannot pay all of its debts under a plan of reorganization *and* continue in business, and that court approval of the termination of the Debtor’s Retirement Plan is appropriate.”⁸⁶ The bankruptcy court has the discretion in determining whether such entity will be unable to pay all debts pursuant to the plan of reorganization unless the plan is terminated.⁸⁷ PBGC-insured private sector defined-benefit pension plans have been terminated or modified in bankruptcy pursuant to 29 U.S.C. § 1341: *In re Kaiser Aluminum Corporation*, where, the court held that an employer in a Chapter 11 bankruptcy may terminate multiple pension plans voluntarily under the reorganization test⁸⁸ and *In re US Airways Group*, where the court held that the financial requirements for a distress termination were met and approved the termination.⁸⁹

83. See 29 U.S.C. § 1341 (2006); *In re Falcon Prods.*, 497 F.3d 838, 840 (8th Cir. 2007).

84. See 29 U.S.C. § 1341; *In re Bastian*, 45 B.R. at 720.

85. The statute provides:

The requirements of this clause are met by a person if—

(I) such person has filed, or has had filed against such person, as of the proposed termination date, a petition seeking reorganization in a case under Title 11 or under any similar law of a State or political subdivision of a State (or a case described in clause (i) filed by or against such person has been converted, as of such date, to such a case in which reorganization is sought), (II) such case has not, as of the proposed termination date, been dismissed, (III) such person timely submits to the corporation any request for the approval of the bankruptcy court (or other appropriate court in a case under such similar law of a State or political subdivision) of the plan termination, and (IV) the bankruptcy court (or such other appropriate court) determines that, unless the plan is terminated, such person will be unable to pay all its debts pursuant to a plan of reorganization and will be unable to continue in business outside the chapter 11 reorganization process and approves the termination.

29 U.S.C. § 1341(c)(2)(B)(i).

86. 287 B.R. 771, 781 (Bankr. W.D. Mo. 2002).

87. 29 U.S.C. § 1341(c)(2)(B)(ii)(IV).

88. See 456 F.3d 328 (3d Cir. 2006).

89. 296 B.R. 734 (Bankr. E.D. Va. 2003).

C. Added Complications of Chapter 9

Private sector pension plans can be modified or terminated by debtors in Chapter 11 bankruptcies.⁹⁰ However, Chapter 9 bankruptcies are more complicated vis-à-vis pension plans. Private sector defined benefit plans are typically insured by the PBGC through ERISA, while public sector defined benefit pension plans are not.⁹¹ ERISA only governs private sector pension plans.⁹² Consequently, there is no federal insurer of public sector pension plans as in the private sector.

While §§ 1113 and 1114 of the Bankruptcy Code govern such plans in the context of a bankruptcy case pending under Chapter 11 of the Code, where private sector defined-benefit plans are at issue, they do not apply in a Chapter 9 bankruptcy involving a municipal debtor.⁹³ Section 1113 provides for extensive requirements that must be met when rejecting a collective bargaining agreement under § 365.⁹⁴ Section 1114 provides more stringent requirements when the debtor is considering modification of insurance benefits to retirees.⁹⁵ Congress enacted both of these provisions in reaction to the ruling in *NLRB v. Bildisco & Bildisco*, where the Supreme Court allowed rejection of a collective bargaining agreement without engaging in further collective bargaining.⁹⁶ Despite the absence of §§ 1113 and 1114 from § 901, *Bildisco* may govern in Chapter 9. *Bildisco* is a decision regarding § 365, which does apply in a Chapter 9 case.⁹⁷ The

90. See 29 U.S.C. § 1341; *In re Bastian Co.*, 45 B.R. 717, 720 (Bankr. W.D.N.Y. 1985).

91. See 29 U.S.C. § 1302 (2006) (noting that one of the purposes of the PBGC is to encourage *private* pension plans).

92. See *id.*

93. 11 U.S.C. § 901 (2012) (omitting §§ 1113 and 1114 from the list of sections of the Bankruptcy Code that apply in Chapter 9).

94. 11 U.S.C. § 1113(c) (2012). The statute provides:

The court shall approve an application for rejection of a collective bargaining agreement only if the court finds that—(1) the trustee has, prior to the hearing, made a proposal that fulfills the requirements of subsection (b)(1); (2) the authorized representative of the employees has refused to accept such proposal without good cause; and (3) the balance of the equities clearly favors rejection of such agreement.

Id.

95. 11 U.S.C. § 1114 (2012).

96. 465 U.S. 513 (1984).

97. 11 U.S.C. § 901 (listing § 365 as a provision that applies in Chapter 9).

2013]

MODIFYING PENSION PLANS

1989

court in *In re City of Vallejo* stated that *Bildisco* applies when interpreting § 365, but not all courts would necessarily agree.⁹⁸

The principles of federalism also complicate public sector pension plans in Chapter 9 bankruptcies.⁹⁹ Chapter 9 governs municipality bankruptcies though federal law while municipality governance is a product of state law. Although ERISA governs private sector pension plans, there is no federal law equivalent governing public sector pension plans, because public sector pension plans are a product of state and local law. These factors make modification of public sector pension plans in a Chapter 9 bankruptcy and the legal rationale behind contested modifications a new area of law.

D. California as the Focus

This Note focuses on public sector pension plans in California for a number of reasons. California has a broad statute enabling its municipalities to file for Chapter 9 protection.¹⁰⁰ This means that California gives broad access for its municipalities to take advantage of the provisions of the Bankruptcy Code allowing municipalities to reorganize. It does not condition its grant of Chapter 9 authority on being a certain class or type of municipality or having a specific type of debt.¹⁰¹ California also has the highest number of Chapter 9 filings of cities or counties to date.¹⁰² This is noteworthy because municipality bankruptcies are rare. Orange County and the City of Vallejo have recently exited bankruptcy. Stockton, Mammoth Lakes, and San Bernadino all filed for Chapter 9 protection within two weeks of one another in July 2012.¹⁰³ Past and present case law is helpful in analyzing municipality bankruptcies.

California state law exacerbates problems facing California municipalities, which could result in more municipality bankruptcies

98. See *In re City of Vallejo*, 403 B.R. 72, 78–79 (Bankr. E.D. Cal. 2009). There is no case law where a court has rejected using *Bildisco* as governing law in Chapter 9 where a collective bargaining agreement is at issue.

99. This issue is further addressed in Part II.A.

100. See CAL. GOV'T CODE § 53760 (West 2012).

101. Compare with Pennsylvania and Alabama's grants of authority.

102. *Surprise! California Not No. 1 in Chapter 9 Filings*, INVESTMENT NEWS (July 16, 2012), <http://www.investmentnews.com/article/20120716/FREE/120719948>. Nebraska has the highest number of Chapter 9 filings, but only of special tax districts, not of cities or counties. *Id.*

103. Jim Christie, *Update 3-San Bernardino 3rd California City to Seek Bankruptcy*, REUTERS (July 11, 2012), <http://www.reuters.com/article/2012/07/11/sanbernardino-bankruptcy-idUSL2E8IB2E520120711>.

1990

FORDHAM URB. L.J.

[Vol. XL

in the future unless the California legislature, or its population through referendum, changes the law to prevent municipalities from taking advantage of Chapter 9 or changing its state labor laws regarding pension plans to be more beneficial to employers in financial distress. CalPERS is favored under state labor law.¹⁰⁴ Pension obligations in California are treated as contractual obligations. This treatment of pension obligations allows for an analysis of whether these contractual obligations are executory contracts subject to rejection in bankruptcy and gives rise to a discussion of what happens after executory contracts are rejected. The California Constitution prohibits municipalities from imposing property taxes exceeding one percent of the property value.¹⁰⁵ This restriction prevents municipalities from raising revenue through raises in property taxes.¹⁰⁶

II. FEDERAL LAW V. STATE LAW AND THE NATURE OF PENSION PLANS

A. Federalism Issues in Chapter 9: Where State and Federal Powers Conflict

Bankruptcy is an area where federal law and state law intersect and as a result, conflict. The federal government derives its power to enact bankruptcy laws from the Constitution.¹⁰⁷ The Constitution explicitly states, “The Congress shall have Power . . . To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.”¹⁰⁸ Therefore, the federal grant of power is exclusive and comes directly from the language of the Constitution.¹⁰⁹ If Congress enacts laws of bankruptcy, any contradictory state law is deemed preempted in the bankruptcy context.¹¹⁰

104. For more information on California state labor law, see *infra* Part II.E.1.

105. CAL. CONST. art. XIII A, §1(a). (“The maximum amount of any ad valorem tax on real property shall not exceed one percent (1%) of the full cash value of such property. The one percent (1%) tax to be collected by the counties and apportioned according to law to the districts within the counties.”).

106. *See id.*

107. U.S. CONST. art. I, § 8, cl. 4.

108. *Id.*

109. *See id.*

110. *See id.*; see also *In re City of Vallejo*, 403 B.R. 72, 77 (Bankr. E.D. Cal. 2009).

2013]

MODIFYING PENSION PLANS

1991

The federal government also has the exclusive power to abrogate contracts.¹¹¹ Bankruptcy is an important tool for financially distressed entities because it allows debtors, either as debtors-in-possession or through a trustee to abrogate contracts that are deemed to not have any net benefit on the estate.¹¹² States cannot abrogate contracts, so debtors must take advantage of the provisions of the Bankruptcy Code in order to do so.¹¹³

The power of state governments also originates from the Constitution. The Tenth Amendment provides that “[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.”¹¹⁴ In the context of bankruptcy, the power to enact laws of bankruptcy has been specifically delegated to the federal government.¹¹⁵ Although Congress has exclusive power to enact bankruptcy laws, Congress has left some room for states to legislate in the context of municipality bankruptcies. Section 903 states,

This chapter 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, but—(1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and (2) a judgment entered under such a law may not bind a creditor that does not consent to such composition.¹¹⁶

This provision leaves room to legislate and respects the sovereignty of states to regulate their municipalities.¹¹⁷ State laws do have some effect in bankruptcy. Section 903 appears to limit the ability of municipalities in Chapter 9 to take full advantage of provisions of the Bankruptcy Code by reserving deference to state law.

111. U.S. CONST. art. I, § 10, cl. 1 (“No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.”).

112. *See, e.g.*, 11 U.S.C. § 362 (2012) (allowing debtors to reject executory contracts); 11 U.S.C. § 363 (2012) (allowing debtors to assign contracts even if the contract prohibits assignment).

113. 11 U.S.C. § 362 (stating that no state may abrogate contracts).

114. U.S. CONST. amend. X.

115. U.S. CONST. art. I, § 8, cl. 4.

116. 11 U.S.C. § 903 (2012).

117. *See id.*

States are also given the authority to dictate whether their municipalities may take advantage of Chapter 9 through the second requirement of § 109—the requirement that states explicitly authorize municipality bankruptcy by statute.¹¹⁸ The court in *In re City of Vallejo* makes clear that states may only prevent municipalities from entering bankruptcy as a threshold issue.¹¹⁹ Once municipalities are in Chapter 9, all provisions listed in § 901 and Chapter 9 apply.¹²⁰ Because each provision of the Bankruptcy Code governs a small aspect of the reorganization, the Bankruptcy Code must be read as a whole. Although states are constitutionally prohibited from abrogating contracts, the federal government may do so and the Bankruptcy Clause allows the federal government to abrogate contracts.¹²¹ Therefore, federal law must trump state law in bankruptcy for municipalities to modify pension obligations, if pension obligations are deemed to be contractual rights.

B. Various State Law Perspectives on the Nature of Pension Plans and Their Ability to be Modified in Bankruptcy

Public pension plans are generally created under state or local law.¹²² Outside of bankruptcy, modification of pension plans depends on state law.¹²³ In bankruptcy, modification of pension plans largely depends on whether the pension plan is an executory contract that can be rejected. There are three main state law perspectives on the nature of pension plans. Pension plans can be viewed as a gratuity, a property right, or a contractual right.¹²⁴ This view has evolved over the years and a majority of jurisdictions, including California, now view pension plans as contractual rights.

Pension plans may be modified or terminated in those jurisdictions that view pension plans as gratuities, as long as payouts to pension plan beneficiaries have not already been made.¹²⁵ These jurisdictions

118. *See supra* text accompanying note 44.

119. *In re City of Vallejo*, 403 B.R. 72, 76 (Bankr. E.D. Cal. 2009).

120. *Id.*

121. *See* U.S. CONST. art I, §10, cl. 1, 4.

122. *See* 29 U.S.C. § 1003(b)(1) (2006).

123. *Pension Plan Modifications Provide Sustainability*, NAT'L INST. ON RETIREMENT SECURITY, (Dec. 5, 2012), <http://www.nirsonline.org/index.php?option=content&task=view&id=733> (stating that forty-five states have enacted defined benefit pension reforms since 2008).

124. Discussed *infra*.

125. *See Menke v. Thompson*, 140 F.2d 786, 790–91 (8th Cir. 1944) (regarding the pension plan of a railroad company outside of bankruptcy).

2013]

MODIFYING PENSION PLANS

1993

view pension plans as gifts from the employer, public or private, that the employees do not have any legal right to, until the benefits are actually paid out.¹²⁶ Since employees generally do not make contributions to the pension plan, the employer may grant or withhold benefits, terminate or withdraw the making of contributions, or completely terminate the pension plan at will.¹²⁷ This view of pension plans as gratuities has changed in most jurisdictions. Jurisdictions that viewed pension plans as gratuities in the past have altered their views regarding pension plans and now view them as either property rights or contractual rights. This change is due to the fact that there is now an expectation of pension benefits upon retirement.¹²⁸ Most public and private sector employees enter into employment with the expectation that there will be some contribution to retirement benefits by the employer that they will receive upon retirement. The view that pension plans are gratuities that can be modified or terminated at the will of the employer has been considered too draconian, and has largely disappeared.

A significant minority of jurisdictions view pension plans as property rights subject to constitutional due process protection. In these jurisdictions, broad modifications of pension benefits may be possible, provided that due process is afforded, especially where the modifications are necessary to preserve the financial viability of the pension plan and to protect the participants' property rights.¹²⁹ *In re Marriage of Roehn* held that a non-employee spouse's future benefits from pension fund are a form of deferred compensation and therefore

126. *See id.*

127. *Neuffer v. Bakery & Confectionery Workers Int'l Union*, 193 F. Supp. 699, 700 (D.D.C. 1961), *aff'd sub nom.*, *Neuffer v. Bakery & Confectionery Workers Int'l Union of Am.*, 307 F.2d 671 (D.C. Cir. 1962).

128. *But see id.* (stating that there is no expectation to pension benefits).

129. *See* U.S. CONST. amend. XIV (“[N]or shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.”); Ellman & Merrett, *supra* note 20, at 382–83 (2011) (citing U.S. CONST. amend. V (“No person shall ... be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.”)); *see also* *Spina v. Consol. Police & Firemen's Pension Fund Comm'n*, 197 A.2d 169, 175 (N.J. 1964) (“[W]e think the employee has a property interest in an existing fund which the State could not simply confiscate.”); *Pierce v. State*, 910 P.2d 288, 304 (N.M. 1995) (“Property rights are also protected under the [D]ue [P]rocess and [E]qual [P]rotection [C]lauses.”); *State ex rel. Horvath v. State Teachers Ret. Bd.*, 697 N.E.2d 644, 648–53 (Ohio 1998) (evaluating legislation modifying the treatment of mandatory contributions to retirement system under Takings Clause and Equal Protection Clause).

property.¹³⁰ *In re Gendreau* held that pension plans are property rights that cannot be discharged.¹³¹ In jurisdictions that view pension plans as property rights, pension plans cannot be modified without due process of law whether they are vested (*In re Marriage of Roehn*)¹³² or unvested (*In re Gendreau*).¹³³ Since these jurisdictions do not view public pensions as contracts, outright rejection under § 365 is not an available tool. Any modification of public pension plans must be made with due process.

In a majority of jurisdictions, including California, employees are recognized to possess an express or implied contractual right to their pension benefits once they begin employment with a municipality. This view has been established through common law, state constitutions, and state statutes. In *Bakenhus v. City of Seattle*, the Washington Supreme Court held that a public “employee who accepts a job to which a pension plan is applicable contracts for a substantial pension and is entitled to receive the same when he has fulfilled the prescribed conditions.”¹³⁴ In *Calabro v. City of Omaha*, the Nebraska Supreme Court held that “a public employee’s constitutionally protected right in his or her pension vests upon the acceptance and commencement of employment, subject to reasonable or equitable unilateral changes by the Legislature.”¹³⁵ *Betts v. Board of Administration of Public Employees’ Retirement System* held that “a public employee’s pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity.”¹³⁶ The Illinois Constitution establishes that pension benefits are contractual rights.¹³⁷ California has enacted state statutes stating pension benefits are

130. *In re Marriage of Roehn*, 576 N.E.2d 560, 562 (Ill. App. Ct. 1991).

131. *In re Gendreau*, 191 B.R. 798, 805 (B.A.P. 9th Cir. 1995), *aff’d*, 122 F.3d 815 (9th Cir. 1997).

132. 576 N.E.2d 560, 562 (Ill. 1991).

133. 191 B.R. 798, 805 (B.A.P. 9th Cir. 1995) *aff’d*, 122 F.3d 815 (9th Cir. 1997).

134. *Bakenhus v. City of Seattle*, 296 P.2d 536, 540 (Wash. 1956).

135. *Calabro v. City of Omaha*, 531 N.W.2d 541, 551 (Neb. 1995).

136. *Betts v. Bd. of Admin. of Pub. Employees’ Ret. Sys.*, 21 Cal. 3d 859, 863 (Cal. 1978).

137. ILL. CONST. art. XIII, § 5.

2013] *MODIFYING PENSION PLANS* 1995

contractual rights that cannot be abrogated.¹³⁸ In jurisdictions where pension plans are contractual rights, such as California, they may be treated as executory contracts that may be rejected in bankruptcy.

Jurisdictions that consider pension plans to be contractual rights generally distinguish between vested and unvested rights, discussed *infra*. The state law concept does not bind federal bankruptcy courts construing the Bankruptcy Code because of the Supremacy Clause,¹³⁹ nevertheless, § 365 has been construed to prevent rejection of vested rights (as the term is understood under federal bankruptcy law).

C. Whether a Pension Plan is an Executory Contract: The Countryman Test

In those jurisdictions where pension plans are viewed as contractual rights, the pension plans may be rejected if they are determined to be executory contracts. Section 365, which permits the rejection of executory contracts,¹⁴⁰ applies in Chapter 9 cases.¹⁴¹ However, the term “executory contract” is not defined in the Bankruptcy Code. While federal bankruptcy law defines the scope and effect of such a rejection, and while the definition of an executory contract is ultimately a federal question, these issues are informed by state law.¹⁴² Countryman’s test, which determines which contracts are executory and which are not, tries to determine precisely what this federal standard is and how it relates to state law concepts of what is executory.

Professor Countryman defines an executory contract as a contract “under which the only obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach

138. CAL. PUB. EMPLOYEES’ RET. SYS., VESTED RIGHTS OF CALPERS MEMBERS, PROTECTING THE PENSION PROMISES MADE TO PUBLIC EMPLOYEES, (2011), available at <http://www.calpers.ca.gov/eip-docs/about/press/news/vested-rights.pdf>.

139. U.S. CONST. art. VI, § 2 (“This Constitution, and the Laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the constitution or laws of any State to the contrary notwithstanding.”).

140. 11 U.S.C. § 365 (2012).

141. 11 U.S.C. § 901 (2012).

142. *Horton v. Rehbein* (*In re Rehbein*), 60 B.R. 436, 440 (B.A.P. 9th Cir. 1986) (“Whether a contract is executory is a question of federal law.”) (citing *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1348 n.4 (9th Cir.1983); *In re Alexander*, 670 F.2d 885, 888 (9th Cir. 1982)).

excusing the performance of the other.”¹⁴³ The Ninth Circuit adopted Countryman’s test.¹⁴⁴ The Supreme Court in *Bildisco* has substantially adopted the same definition.¹⁴⁵ Under this definition, vested rights typically do not qualify as an executory contract, whereas unvested rights would qualify as an executory contract.

Whether and when a pension plan vests and whether the pension plan is vested or unvested at the time a bankruptcy petition is filed is a matter of federal law that is informed by state law. Whether the contract is executory can turn on whether the pension plan has vested. The state law concept does not bind federal bankruptcy courts construing the Bankruptcy Code because of the Supremacy Clause; nevertheless, § 365 has been construed to prevent rejection of vested rights (as the term is understood under federal bankruptcy law).

The bankruptcy court in *In re Bastian Co.*, which involved a private employer in Chapter 11 with an ERISA-governed plan, held that pension plans are executory contracts subject to § 365 because performance remains on both sides.¹⁴⁶ Employees need to work for continued pension contributions and the employer needs to continue contributing to the pension plan in order to compel employee performance.¹⁴⁷ *In re Philip Service Corporation*, on the other hand, held that distress termination of an unvested private sector pension plan was not allowed under ERISA and the debtor may not reject an ERISA-governed pension plan as an executory contract.¹⁴⁸ A bankruptcy court in Texas determined that a specific statute (ERISA) trumps a general, broad statute (Bankruptcy Code).¹⁴⁹ The courts are therefore divided as to whether unvested pension plans can be rejected as executory contracts.

The Seventh Circuit in *In re UAL Corp. (Pilots’ Pension Plan Termination)* held that the “[t]ermination’ of a plan does not end anyone’s right to receive vested benefits; it just prevents an increase

143. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

144. See *In re Alexander*, 670 F.2d 885, 887 (9th Cir. 1982).

145. See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 & n.6 (1984).

146. *In re Bastian Co.*, 45 B.R. 717, 721 (Bankr. W.D.N.Y. 1985) (“Similarly, there is no provision in the Bankruptcy Code excluding pension plans from § 365. Therefore, pension plans are rejectable as executory contracts under 11 U.S.C. § 365.”).

147. *Id.* at 720–21.

148. 310 B.R. 802, 809 (Bankr. S.D. Tex. 2004).

149. *Id.*

2013]

MODIFYING PENSION PLANS

1997

in those benefits, which will be paid from the trust and, to the extent that fund is insufficient, by the Pension Benefit Guaranty Corporation.”¹⁵⁰ The Pennsylvania bankruptcy court in *In re Alan Wood Steel Co.* found that a pension plan with vested participants was not a wholly executory contract and could not be rejected.¹⁵¹

The debtor, by the completion of the plan-participants’ age and service requirements for vesting under the plans, has received all of the consideration for which it bargained with its employees. The contracts between them are executed except for the debtor’s obligation to pay the specified benefits in the case of the Hourly Plan, and make certain accrued periodic contributions under the Salaried Plan. By a “rejection” the debtor would be relinquishing no benefits; it would merely be repudiating its obligations.¹⁵²

The bankruptcy courts are generally in agreement that once a pension plan has vested, the contract is no longer wholly executory and cannot be rejected as such.

Where pension obligations are tied to a collective bargaining agreement, the municipality may have to reject the entire agreement in order to reject the pension obligation, provided that the collective bargaining agreement is viewed as a single contract. Occasionally, the collective bargaining agreement is viewed as separate contracts. In this situation, one portion, as long as determined to be executory may be rejected pursuant to § 365. Section 365 of the Bankruptcy Code does not allow a debtor to “cherry pick” which portions of contracts to assume or reject, but rather the debtor must assume reject the contract in its entirety.¹⁵³

Courts have held that private sector pension plans are executory contracts rejectable in bankruptcy.¹⁵⁴ A bankruptcy court in New York in *In re McFarlin’s Inc.*, held that the collective bargaining agreement upon which a pension plan was based was an executory contract that could be rejected in bankruptcy and thus the claim

150. 468 F.3d 444, 447 (7th Cir. 2006).

151. No. 77-930, 1978 U.S. Dist. LEXIS 20428, at *51 (Bankr. E.D. Pa. Dec. 29, 1978).

152. *Id.* at *16.

153. *Pieco, Inc. v. Atl. Computer Sys.*, 173 B.R. 844, 849 (Bankr. S.D.N.Y. 1994) (citing *Hurly v. Atchison, Topeka & Santa Fe Ry.*, 213 U.S. 126 (1909); *In re Grayson-Robinson Stores, Inc.*, 321 F.2d 500, 502 (2d Cir. 1963)).

154. *See, e.g., In re Am. R. Co. of P.R.*, 110 F. Supp. 45 (D.P.R.1952), *aff’d*, 202 F.2d 149 (1st Cir. 1953); *see also In re Alan Wood Steel Co.*, No. 77-930, 1978 U.S. Dist. LEXIS 20428 (Bankr. E.D. Pa. Dec. 29, 1978), *aff’d*, 449 F. Supp. 165 (E.D. Pa. 1978).

would be treated as a general unsecured claim.¹⁵⁵ The claim would not be treated as a first priority under § 507(a), which contemplates administrative claims, including costs of running a business in bankruptcy, having a priority over general unsecured claims.¹⁵⁶ Subtitle E of ERISA, 29 U.S.C. § 1381, from the Multiemployer Pension Plan Amendments of 1980 deals with unfunded vested pension plan interests and withdrawal liability for the employer.¹⁵⁷ Congress excluded collective bargaining agreements from the Railway Labor Act but not the National Labor Relations Act, thereby demonstrating that Congress knew how to exclude collective bargaining agreements when it wanted to.¹⁵⁸ Its failure to exclude collective bargaining agreements from § 365 may indicate that it meant to include collective bargaining agreements.¹⁵⁹ *In re Wheeling-Pittsburgh Steel Corp.* also held that pension plans are executory contracts.¹⁶⁰ In *In re Robinson Truck Line*, a Mississippi bankruptcy court held that a Chapter 11 debtor could assume the private sector pension plan as an executory contract upon the adequate assurance of a prompt cure of prepetition arrearages rather than upon immediate cash payment of the total arrearage on the effective date of the Chapter 11 plan, and that the prepetition arrearage could be classified with priority for unsecured claims for contributions to the employee benefit plan.¹⁶¹ This treatment is exactly what is required under § 365 for rejection or assumption of an executory contract.¹⁶² This line of case law addressing private sector pension plans as executory contracts subject to rejection under § 365 in a bankruptcy case indicates that this option may also be available in a municipality bankruptcy dealing with public sector pension plans, provided that the pension plan has not already vested.

California's municipalities have a contractual relationship with CalPERS, the administrator of its public employee pension plans.¹⁶³

155. *In re McFarlin's Inc.*, 46 B.R. 88, 90 (Bankr. W.D.N.Y. 1985).

156. *Id.* at 90.

157. *Id.* at 89.

158. *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 525–26 (1984).

159. *Id.*

160. 103 B.R. 672 (Bankr. W.D. Pa. 1989).

161. 47 B.R. 631 (Bankr. N.D. Miss. 1985).

162. 11 U.S.C. § 365 (2012).

163. CalPERS' Brief in Support of the City of Stockton's Petition at 5, *In re City of Stockton*, Cal., No. 12-32118 (E.D. Cal. June 28, 2012), ECF No. 711. The brief states:

2013] *MODIFYING PENSION PLANS* 1999

This contract may also be analyzed to determine if it is executory. California municipalities are obligated to make contributions to CalPERS in return for CalPERS continuing to administer their public sector pension plans.¹⁶⁴ CalPERS claims that the relationship between the municipality and CalPERS is contractual, established by statute and common law.¹⁶⁵ If the relationship is a contract, it appears to be executory under Countryman's test, because there are obligations left for both municipalities and CalPERS.

D. Rejection as a Prepetition Breach of Contract

Rejection has been compared to a prepetition breach of contract. As such, rejection results in a prepetition claim against the estate for breach of that contract. A debtor's ability to reject or assume contracts often results in negotiation in the shadow of this law.

E. Federalism Issues Regarding Treatment of the Pension Plan as a Prepetition Breach of Contract Claim

Once a public pension plan has been rejected as an executory contract and a claim has been filed against the estate as a prepetition breach of contract claim, state law and federal law may conflict regarding how the claim will be treated in bankruptcy. Whether state law or federal law is binding determines how a pension plan may be treated in bankruptcy. Here, California state labor law and federal law are analyzed because California state law and federal bankruptcy law are the most at odds.

For public employees serving municipalities in California, CalPERS provides retirement benefits to employees through a three-way structure: (1) the municipality has a "contract" with CalPERS that triggers statutes and other laws governing the provision of pension benefits through CalPERS; (2) the public servant has an employment contract with the municipality that includes pension benefits; and (3) CalPERS has a fiduciary responsibility to provide and protect the pension benefits of its employee members. This three-way structure is the basis for the trust relationship between the parties where the municipality is the trustor, the members are the beneficiaries and CalPERS is the trustee.

Id.

164. *See id.* at 2 ("The relationship between CalPERS and the City is executory in nature: 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. The City's obligations to CalPERS are not negotiable.").

165. *See id.* at 5-6.

2000

FORDHAM URB. L.J.

[Vol. XL

1. Treatment Under California State Labor Law

Under California state law, there is generally a vested/unvested distinction, where unvested pension plans may be modified or terminated, whereas vested rights cannot be impaired.¹⁶⁶ This is true even if the pension plan has been rejected as an executory contract. Whether the claim against the bankruptcy estate can be impaired through a plan of reorganization also depends on this distinction.

A state's distinction between vested and unvested rights may differ from that of federal law. In California, pension plans vest on the first day of employment¹⁶⁷ because state statutes create contractual rights on the first day of employment.¹⁶⁸ These rights are private contractual rights, as explained by the court in *California Teachers Association*: “[the] statute offering pension rights in return for employee services expresses an element of exchange and thereby implies these rights will be private rights in the nature of contract.”¹⁶⁹

Early California labor law allowed for flexibility in modifying pension plans. *Kern* provided for “reasonable modifications” stating that “pension systems must be kept flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system and carry out its beneficent policy.”¹⁷⁰ After *Kern*, California courts adopted a new rule regarding pension plans, ruling that changes are to be consistent with the theory of a pension system and that all detrimental changes be offset by “comparable new advantages.”¹⁷¹ Twelve other states have adopted California's rule in *Allen* requiring “comparable new advantages” when modifying a pension plan.¹⁷² This new rule limits employers within the state's

166. See, e.g., Amy B. Monahan, *Statutes As Contracts? The “California Rule” and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1050–51 (2012) (describing California's distinction between vested and unvested pension plans).

167. *Betts v. Bd. of Admin. of the Pub. Employees' Ret. Sys.*, 582 P.2d 614, 617 (Cal. 1978) (en banc) (stating that the right to a “substantial” or “reasonable” pension accrues on first day of employment).

168. Monahan, *supra* note 166, at 1046.

169. *Cal. Teachers Ass'n v. Cory*, 202 Cal. Rptr. 611, 618 (Ct. App. 1984).

170. *Kern v. City of Long Beach*, 179 P.2d 799, 803 (Cal. 1947) (en banc).

171. *Allen v. City of Long Beach*, 287 P.2d 765, 767 (citing *Wallace v. City of Fresno*, 265 P.2d 884, 887–88 (Cal. 1954); *Packer v. Bd. of Ret. of L.A. Cnty. Peace Officers' Ret. Sys.*, 217 P.2d 660, 661–62, 664–65 (Cal. 1950) (en banc)).

172. Monahan, *supra* note 166, at 1071. These states are Alaska, Colorado, Idaho, Kansas, Massachusetts, Nebraska, Nevada, Oklahoma, Oregon, Pennsylvania, Vermont, and Washington. *Id.* Compare this list with the list of states that allow broad access to Chapter 9. Those states that allow broad access to Chapter 9 and

2013]

MODIFYING PENSION PLANS

2001

ability to make changes to pension benefits of all current employees. For example, a statutory change adding a new dollar-amount maximum for pension benefits was impermissible because the change came with no comparable advantage to participants.¹⁷³ As a result, pension benefits cannot be detrimentally changed, even if the change is only prospective. These new advantages must also be contemporaneous with detrimental changes.¹⁷⁴ California courts later expanded their rule even further to limit modifications to future accruals. In *Legislature v. Eu*, the California Supreme Court went even further than the court in *United Firefighters*, explicitly recognizing the “collateral right to earn future pension benefits through continued service, on terms substantially equivalent to those then offered.”¹⁷⁵ This means that even the rate of *future* accruals cannot be altered.¹⁷⁶ California courts have never explained why future accruals must be protected, especially since public employees can be fired and their compensation lowered.¹⁷⁷

In states like California, where state labor laws and public policy concerns favor employees, states may argue that their laws apply in treatment of claims in bankruptcy. The states may cite to other areas of bankruptcy where the Bankruptcy Code allows deference to state law. These provisions include § 522, under which debtors may opt to take state law exemptions instead of the federal exemptions of personal assets from the bankruptcy estate.¹⁷⁸ Bankruptcy courts

have adopted California’s rule in *Allen* will face similar problems to California when trying to negotiate changes to pension plans in bankruptcy.

173. *Chapin v. City Com’n*, 307 P.2d 657, 660 (Cal. Dist. Ct. App. 1957).

174. *See Betts v. Bd. of Admin. of the Pub. Employees’ Ret. Sys.*, 582 P.2d 614, 619 (Cal. 1978) (improvement enacted in 1963 could not be used to justify detrimental change in 1974); *Abbott v. City of San Diego*, 332 P.2d 324, 329 (Cal. Dist. Ct. App. 1958).

175. *Legislature v. Eu*, 816 P.2d 1309, 1331 (Cal. 1991).

176. *Id.*; *Allen v. City of Long Beach*, 287 P.2d 765 (Cal. 1955).

177. *Monahan*, *supra* note 166, at 1077.

178. 11 U.S.C. § 522 (2012). Section 522 provides in pertinent part:

(3) Property listed in this paragraph is—(A) subject to subsections (o) and (p), any property that is exempt under Federal law, other than subsection (d) of this section, or State or local law that is applicable on the date of the filing of the petition to the place in which the debtor’s domicile has been located for the 730 days immediately preceding the date of the filing of the petition or if the debtor’s domicile has not been located in a single State for such 730-day period, the place in which the debtor’s domicile was located for 180 days immediately preceding the 730-day period or for a longer portion of such 180-day period than in any other place.

Id. (b)(3)(A).

have also given great deference to states in how to treat severance pay to employees, whether as an administrative expense in bankruptcy, which is given the second priority under § 507, or as a prepetition claim.¹⁷⁹

States that want their state labor laws to apply may argue that § 943(b)(4) prevents the bankruptcy court from confirming a plan of reorganization that impairs pension plans in violation of state law.¹⁸⁰ If impairing vested pension plans is a violation of state law, as it is in California under its definition of what it means to be a vested plan, then the bankruptcy court cannot confirm a plan that impairs pension plans. However, what § 943(b)(4) means as applied to Chapter 9 bankruptcies can be compared with § 1129 requirements for plan confirmation in Chapter 11 bankruptcies. Section 1129 also contains a provision where a plan cannot be confirmed if the plan includes modifications that violate state law or nonbankruptcy federal law outside of bankruptcy.¹⁸¹

CalPERS, in its brief in the Stockton bankruptcy case in support of Stockton's eligibility, argues that state law protects public employee pension funds and prevents California and its municipalities from "raiding pension funds to balance the State budget."¹⁸² CalPERS argues that under California state law, including the California Constitution, municipalities are unable to modify public pension plans subject to CalPERS administration.¹⁸³ This relationship is

179. 11 U.S.C. § 507 (2012).

180. 11 U.S.C. § 943(b)(4) (2012) ("The court shall confirm the plan if . . . (4) the debtor is not prohibited by law from taking any action necessary to carry out the plan.").

181. 11 U.S.C. § 1129(a)(16) (2012) ("All transfers of property under the plan shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust.").

182. Brief for Petitioner at 6, *In re* City of Stockton, Cal., No. 12-32118 (Bankr. E.D. Cal. June 28, 2012), ECF No. 711. The brief states:

Proposition 162 amended the California Constitution to provide that the CalPERS Board has "the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets" of the system. CAL. CONST., art. XVI, sec. 17, subd. (e). The intent behind the measure was to protect public pension funds by vesting the authority to direct actuarial determinations solely with the governing board. *See* Lubic Dec., Exhibit 4 at 36 (Relevant Portions of Official Ballot Pamphlet (Nov. 3, 1992)). By granting the CalPERS Board sole authority to administer the system, Proposition 162 prevented the legislative and executive branches from "raiding" pension funds to balance the State budget.

Id. at 38.

183. *See id.* at 9.

2013] *MODIFYING PENSION PLANS* 2003

defined by state law.¹⁸⁴ CalPERS further argues that Stockton may terminate its relationship with CalPERS, but it would then be required to make a termination payment to CalPERS in an amount that would be sufficient to ensure that all accrued pension benefits can be paid.¹⁸⁵ If Stockton terminates its relationship with CalPERS, its termination payment would be about \$950 million, as determined by CalPERS.¹⁸⁶ CalPERS therefore argues that under relevant state law, termination is not a viable option for Stockton.¹⁸⁷

2. *Treatment Under Federal Bankruptcy Law*

Under federal law, the vested/unvested distinction merely confirms the existence of a contractual obligation. While state law and state actors are constitutionally unable to abrogate contracts, federal law is not constrained by the Contract Clause in the US Constitution.¹⁸⁸ The Bankruptcy Code is consistent with this view in allowing rejection of executory contracts and modification of contracts through a plan of reorganization.

Once rejected, a claim for a prepetition breach of an executory contract (here, pension obligations) can be treated through a plan of reorganization.¹⁸⁹ They must be part of executory contract (i.e. someone who has already retired is no longer party to an executory contract since the retiree presumably has fulfilled all material obligations of the contract and all that is left is for the municipality to fulfill its obligation to make pension plan contributions). There is prior case law involving bankruptcies in both the private sector and the public sector regarding such modifications.

There is precedent involving treatment of rejected Chapter 11 pension plans in bankruptcy. In a Chapter 11 bankruptcy involving an unvested private sector employer, the court treated the rejected executory contract, which included a pension plan, as a claim against

184. *Id.* at 9.

185. *Id.* at 13.

186. *Id.* at 14–15.

187. *Id.* at 15–18.

188. U.S. CONST. art. I, § 10, cl. 1. The Contract Clause provides:

No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

Id.

189. *See* 11 U.S.C. § 502 (2012).

2004

FORDHAM URB. L.J.

[Vol. XL

the estate and a general unsecured claim in bankruptcy.¹⁹⁰ The claim was not treated as a priority under § 507(a), which contemplates administrative claims, including costs of running a business in bankruptcy, having a priority over general unsecured claims.¹⁹¹

There are also two examples of municipalities in Chapter 9 that have modified or terminated pension plans in bankruptcy. First, Prichard, Alabama, filed for Chapter 9 protection in the United States Bankruptcy Court for the Southern District of Alabama on October 27, 2009.¹⁹² Pension obligations owed to former municipal employees was among the causes of Prichard's filing.¹⁹³ Pension debt was also among the causes of Prichard's 1999 filing for Chapter 9 protection.¹⁹⁴ The plan of reorganization in Prichard's first filing mandated a \$16.5 million increase in the pension fund.¹⁹⁵ However, this plan provision was never implemented, resulting in an increased retirement fund burden for the city.¹⁹⁶ The pension fund finally ran out of money nine years after the 2010 plan was confirmed in September 2009.¹⁹⁷ In response, the city simply stopped paying out pensions to its retirees.¹⁹⁸ The retirees sued to enforce the 2010 plan

190. *In re* McFarlin's Inc. 46 B.R. 88, 90 (Bankr. W.D.N.Y. 1985).

191. *Id.*

192. Chapter 9 Voluntary Petition at 1, *In re* City of Prichard, Ala., No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009), ECF No. 1.

193. *See* Brief for Petitioner at 1, *In re* City of Prichard, Ala., No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009), ECF No. 36. The brief states:

On August 13, 2009, the Prichard Retirees filed a complaint in the Circuit Court of Mobile County against the Debtor, the City of Prichard ("the Debtor" or "the City"), as well as Mayor Ron Davis and all five City Council Members for the City of Prichard. In Count One of their complaint, the Prichard Retirees allege that the defendants negligently failed to take steps to ensure the financial viability of the Prichard Pension Fund. In Count Two, the Prichard Retirees request that circuit court declare that the City violated this Court's previous order dated October 6, 2000, which required the City to provide for the appropriate incremental \$16.5 million payment to the Pension Fund, and enter judgment against the City for that amount. Finally, in Count Three, the Prichard Retirees allege that City Council Members Napoleon Bracy, Herman Towner and Troy Ephriam, individually and in their capacities as members of the Board of Pension, breached their fiduciary duties to the Prichard Retirees, causing the Retirees to suffer damages. The Retirees demanded trial of their claims by jury.

Id. at 1.

194. *See* Ellman & Merrett, *supra* note 20, at 387.

195. *See id.*

196. Hueske, *supra* note 14.

197. *Id.*

198. *Id.*

2013] *MODIFYING PENSION PLANS* 2005

provisions, causing Prichard to seek Chapter 9 protection again.¹⁹⁹ Prichard proposed to restructure and cap the outstanding pension obligations owed to municipal retirees in its May 2010 plan.²⁰⁰ Their plan faced many objections from creditors resulting in amended versions of their plan for adjustment.²⁰¹

On August 11, 2010, Prichard's creditors filed a motion to dismiss the Chapter 9 case, arguing that the city had never been authorized to seek Chapter 9 relief under the laws of Alabama, because it had no 'refunding or funding' bond debt as allegedly required under section 11-81-3 of the Alabama Code, and therefore did not satisfy the requirements for being a 'debtor' under Bankruptcy Code § 109(c).²⁰²

The bankruptcy court granted the motion to dismiss and Prichard appealed.²⁰³ The bankruptcy court stayed the case while the Alabama Supreme Court decided whether section 11-81-3 of the Alabama Code grants all municipalities authority to seek relief under Chapter 9, or if such relief is limited to municipalities holding "refunding or funding debt."²⁰⁴

In Central Falls, Rhode Island, pension plan reductions were negotiated according to the City's fourth amended plan of reorganization, confirmed on September 11, 2012.²⁰⁵ Classes 9 and 10 were to be impaired classes of retirees.²⁰⁶ Class 9 retirees' pensions

199. *Id.*

200. Chapter 9 Plan of Adjustment at 8-9, *In re* City of Prichard, Ala., No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009), ECF No. 134.

201. Prichard filed five amended plans. Fifth Amended Plan of Adjustment, *In re* City of Prichard, Ala., No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009), ECF No. 296.

202. Hueske, *supra* note 14; *see also* Motion to Dismiss Bankruptcy Case, *In re* City of Prichard, Ala., No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009), ECF No. 186.

203. Order Granting Motion to Dismiss Case, *In re* City of Prichard, Ala., No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009), ECF No. 202; Notice of Appeal to District Court, *In re* City of Prichard, Ala., No. 09-15000 (Bankr. S.D. Ala. Oct. 27, 2009), ECF No. 217.

204. Hueske, *supra* note 14.

205. Order Confirming Chapter 9 Plan at 2, *In re* City of Central Falls, R.I., No. 11-13105 (D.R.I. Aug. 1, 2011), ECF No. 572; Chapter 9 Plan Fourth Amended Plan for the Adjustment of Debts Filed by Debtor The City of Central Falls, Rhode Island, *In re* City of Central Falls, R.I., No. 11-13105 (Bankr. D.R.I. Aug. 1, 2011), ECF No. 479.

206. Chapter 9 Plan Fourth Amended Plan for the Adjustment of Debts Filed by Debtor The City of Central Falls, Rhode Island, *In re* City of Central Falls, R.I., No. 11-13105 (Bankr. D.R.I. Aug. 1, 2011), ECF No. 479. Members of Class 9 and 10 are listed in Exhibits G and H of the plan, respectively. *Id.* There are five members in Class 9, whose retirement benefits prior to the Chapter 9 filing are unclear, although it can be assumed that their benefits prior to the Chapter 9 filing were greater than

will be reduced to \$10,000 and class 10 retirees' pension would be reduced by fifty-five percent.²⁰⁷ The impaired classes under the Central Falls' plan also included members who were already retired, where the benefits presumably already vested.²⁰⁸ Because both the Central Falls and Prichard cases involved reducing pension plans that were already vested (they were already retired and receiving checks), these cases indicate that both vested and unvested pension plans may be modified or terminated in bankruptcy.

A cram down, where the bankruptcy court may impose a plan of reorganization over the objection of some impaired classes, is available under federal bankruptcy law and possibly applies to Chapter 9 bankruptcies.²⁰⁹ Section 1129 has been incorporated into Chapter 9 through § 901.²¹⁰ Section 1129 deals with a cram down on creditors—impaired classes that do not agree with the plan of reorganization proposed.²¹¹ Under Chapter 11, meeting § 1129 requirements if an impaired class does not vote in favor the plan of reorganization requires the bankruptcy court to find that the plan is fair and equitable to all creditors before confirming the plan.²¹² The fair and equitable requirement can be met in Chapter 11 as long as the absolute priority rule is met.²¹³ However, the absolute priority rule cannot be met in Chapter 9 because municipalities cannot liquidate, and an analysis of what would occur if the municipality were to liquidate cannot be conducted.²¹⁴ Therefore, the test in a Chapter 9 case for the fair and equitable requirement is whether what the impaired class is to receive under the plan of reorganization is all they can reasonably expect under the circumstances²¹⁵ This requires the bankruptcy court to determine if the amount to be payable to an impaired class is fair given their level of priority in the bankruptcy case and whether it is fair given the situation.²¹⁶ The court may

\$10,000 because they are listed as an impaired class. *Id.* at Exhibit G. There are thirty-five members in Class 10. *Id.* at Exhibit H.

207. *Id.*

208. *Id.*

209. *See* 11 U.S.C. § 1129(b)(1) (2012).

210. 11 U.S.C. § 901 (2012).

211. *See* 11 U.S.C. § 1129 (b)(1).

212. *Id.*

213. 11 U.S.C. § 1129(b)(2)(B).

214. *Newhouse v. Concoran Irrigation Dist.*, 114 F.2d 690, 691 (9th Cir. 1940).

215. *Lorber v. Vista Irrigation Dist.*, 127 F.2d 628, 639 (9th Cir. 1942) (citing *West Coast Life Ins. Co. v. Merced Irrigation Dist.*, 114 F.2d 654, 679 (9th Cir. 1940)).

216. *Id.*

2013] *MODIFYING PENSION PLANS* 2007

consider factors inherent in the running of a municipality.²¹⁷ Generally, however, courts give great deference to the municipality in determining what is fair.²¹⁸

III. PENSION PLANS MAY BE REJECTED AS EXECUTORY CONTRACTS

This discussion of rejecting pension plans as executory contracts must be limited to jurisdictions that view pension plans as executory contracts, because only those pension plans fall within § 365. In jurisdictions such as California, where public employees' rights under pension plans are viewed as contractual rights, pension plans may be rejected as executory contracts pursuant to § 365 as applied at a Chapter 9 municipal reorganization proceeding.²¹⁹ The extent to which rejection amounts to a modification of pension plan obligations will depend upon the extent to which these obligations have "vested" under federal law.²²⁰ States may have varying definitions of what it means to be "vested" and California does have a very different definition of a vested pension plan within the state.²²¹ Although federal law can be informed by state law definitions, due to federalism concerns and an interest in uniformity in administering bankruptcy estates, federal law ultimately trumps state law in the bankruptcy context.²²² This makes sense, given the Supremacy Clause, Bankruptcy Clause, and Contracts Clause of the Constitution. Municipalities may, therefore, use the tools available in bankruptcy to reorganize debt and better provide for their constituencies going forward.

In those jurisdictions that view pension plans as contractual rights, pension plans may be rejected under § 365 if they are found to be executory contracts.²²³ Pension plans of current employees are executory because there are obligations left to be performed on both sides to the contract.²²⁴ The employee must continue to work for the employer and the employer must continue to pay the employee and

217. *In re Corcoran Hospital Dist.*, 233 B.R. 449, 459 (Bankr. E.D. Cal. 1999).

218. 11 U.S.C. § 928(b) (2012); *Newhouse*, 114 F.2d at 690.

219. *See* discussion *supra* Part II.E.1.

220. *See* discussion *supra* Part II.E.2.

221. *See* discussion *supra* Part II.E.1.

222. *See* discussion *supra* Part II.E.2.

223. *See* discussion *supra* Part II.C.

224. *See* discussion *supra* Part II.C.

contribute to the pension plan.²²⁵ Since there are obligations left on both sides, a pension plan as part of an employment contract is an executory contract under the Countryman test that can be rejected under § 365.²²⁶ Section 365 does not, however, permit rejection of employment contracts of employees who have already retired.²²⁷ Rejection under § 365 only applies to executory contracts—it does not permit “rejection” in the absence of mutual performance obligations; it also does not permit “rejection” of vested rights, which must otherwise be respected in bankruptcy and in a plan of reorganization.²²⁸ These are not executory contracts because the only meaningful obligation left is for the employer to contribute to the pension plans.²²⁹ These rights have already been vested under federal law and cannot be abrogated.²³⁰ The municipality may, however, negotiate a modification with the retirees, as was the case in Prichard, Alabama and Central Falls, Rhode Island.²³¹

Once rejected, these pension plans can be treated under a plan of reorganization allowing for modification of pension plan obligations.²³² A cram down is allowed under the Bankruptcy Code because § 1129 has been incorporated into Chapter 9.²³³ If public pensioners as an impaired class do not vote in favor of the plan of reorganization, the court can still confirm the plan if it is fair and equitable as to all creditors.²³⁴ The debtor may negotiate with employees with both vested and unvested rights.²³⁵ Nevertheless, a cram down is only applicable if the rights have not vested under federal law.²³⁶ In states like California, where the state views pension plans as “vested” on the first day of employment, the right may not be “vested” under federal law.²³⁷ Federal law definitions are binding.²³⁸

225. See discussion *supra* Part II.C.

226. See discussion *supra* Part II.C.

227. See discussion *supra* Part II.C.

228. See discussion *supra* Part II.C.

229. See discussion *supra* Part II.C.

230. See discussion *supra* Part II.E.1.

231. See discussion *supra* Part II.E.2.

232. See *supra* note 187 and accompanying text.

233. See *supra* notes 207–210 and accompanying text.

234. See *supra* notes 207–210 and accompanying text.

235. See *supra* notes 207–210 and accompanying text.

236. See *supra* notes 207–210 and accompanying text.

237. See discussion *supra* Part II.A.

238. See discussion *supra* Part II.A.

2013] *MODIFYING PENSION PLANS* 2009

As such, the pension plans of those who have not yet retired or qualify to retire may be modified in bankruptcy.²³⁹

In California, where pension plans have been determined to be contractual rights, pension plans that are unvested under federal law are executory contracts despite any state law to the contrary.²⁴⁰ Furthermore, the relationship between CalPERS and state agencies and municipalities is executory, as conceded by CalPERS.²⁴¹ This relationship can, therefore, also be rejected as an executory contract subject to a prepetition breach of contract claim.²⁴² As such, the “termination payment” determined by CalPERS, may be negotiated as part of a bankruptcy case.²⁴³

Since public sector pension plans in jurisdictions that view pension plans as contractual rights may be modified in bankruptcy, Congress and state legislatures must balance allowing municipalities to reorganize and meet obligations in their confirmed plans with protecting future retirees. Congress can help municipalities by enacting a section of the Bankruptcy Code specifically allowing for the rejection of public pension plans as executory contracts to dissolve some of the uncertainty and hesitation with modification of public sector pension plans. State legislatures may also enact laws that are more favorable to municipalities in bankruptcy. In the alternative, if public policy dictates protecting public pensioners, Congress may enact a statute similar to ERISA in insuring public sector pension plans. State legislatures may also further limit access to Chapter 9 to municipalities that do not have pension debt. State legislatures may also enact a statute insuring public sector pension plans within the state.

CONCLUSION

Chapter 9 is a seldom-used tool for eligible municipalities to organize their debts. Although Chapter 9 filings are rare, they are becoming more widely used by municipalities that have, in good faith, exhausted all other mechanisms of renegotiating and reorganizing their debts. In many municipalities facing bankruptcy, public employee pensions are a growing concern, with underfunded pension

239. See discussion *supra* Part II.E.2.

240. See discussion *supra* Part II.E.1.

241. See discussion *supra* Part II.E.1.

242. See discussion *supra* Part II.E.1.

243. See discussion *supra* Part II.E.1.

plans.²⁴⁴ Because there is little case law on the treatment of pensions in Chapter 9, treatment of pensions in Chapter 11 may be analogous to how pension plans may be treated under Chapter 9.²⁴⁵ As such, treatment of pensions in Chapter 11 must be examined.²⁴⁶ However, Chapter 9 adds complications because of issues of federalism and limits on the power of the bankruptcy court.²⁴⁷

In jurisdictions such as California, where public employees' rights under pension plans are viewed as contractual rights, pension plans may be rejected as executory contracts, pursuant to § 365, as applied at a Chapter 9 municipal reorganization proceeding.²⁴⁸ The extent to which rejection amounts to a modification of pension plan obligations will depend upon the extent to which these obligations have "vested" under federal law.²⁴⁹ Although there are competing definitions of what it means to be "vested," the federal law definition ultimately binds municipalities availing themselves of the protection of Chapter 9, a federal bankruptcy law concept.²⁵⁰ Once pension plans are rejected as executory contracts, claims for breach of that executory contract are treated as prepetition claims under § 365.²⁵¹ As such, these claims may be dealt with in a plan of reorganization.²⁵² In this plan, certain classes of creditors, including public employees with these claims for prepetition breach of contract, may be impaired.²⁵³ As an impaired class, these public employees are granted voting rights in deciding whether to approve the proposed plan of reorganization filed by the municipality.²⁵⁴ Although it is preferred that the impaired class vote in favor of the plan, a cram down is available, where the court may impose the plan on creditors who do not vote in favor of the plan.²⁵⁵ Because the cram down is involuntary on the part of impaired creditors, the court must first make a finding that the plan is fair and equitable.²⁵⁶ Once this finding is made, the

244. *See generally supra* Introduction.

245. *See generally supra* Part I.

246. *See generally supra* Part I.

247. *See generally supra* Part I.

248. *See discussion supra* Part II.C.

249. *See discussion supra* Part II.E.2.

250. *See discussion supra* Part II.A.

251. *See discussion supra* Part II.D.

252. *See discussion supra* Part II.E.

253. *See discussion supra* Part II.E.

254. *See discussion supra* Part II.E.

255. *See discussion supra* Part II.E.2.

256. *See discussion supra* Part II.E.2.

2013] *MODIFYING PENSION PLANS* 2011

court may approve the plan and the municipality may exit Chapter 9.²⁵⁷ The municipality must then fulfill its obligations under the plan.²⁵⁸ Thus, municipalities may use the tools available in bankruptcy to reorganize debt and better provide for their constituencies going forward.

257. See discussion *supra* Part II.E.2.

258. See discussion *supra* Part II.E.2.