HOW MUNICIPALITIES IN FINANCIAL DISTRESS SHOULD DEAL WITH UNFUNDED PENSION OBLIGATIONS AND APPROPRIATE FUNDING OF ESSENTIAL SERVICES

JAMES E. SPIOTTO*

TABLE OF CONTENTS

I. SUMMARY 516
II. THE CURRENT SITUATION 519
III. MUNICIPALITIES AND THE EVOLUTION OF PUBLIC PENSIONS 521
A. Growth of Municipalities and Public Services 521
B. Growth of Public Pensions 523
C. Description of the Current Dilemma 526
IV. LEGAL PROTECTIONS PROVIDED FOR PUBLIC PENSIONS 526
A. Historical Development of the Law 526
B. Current State of the Law 527

* Mr. Spiotto is the Managing Director of Chapman Strategic Advisors LLC and Co-Owner and Co-Publisher of MUNINET GUIDE, an online resource specializing in municipal-related research and information concerning state and local governments, including public finance, infrastructure, job market data and economic statistics and analysis. This presentation discusses Chapter 9 and the necessity of a recovery plan that would provide sufficient funding for necessary essential services and needed infrastructure at an acceptable level that is not crowded out by demands for the payment of unfunded pension obligations and other debt obligations. For further reading: Remarks of James E. Spiotto of Chapman and Cutler LLP to the U.S. Securities and Exchange Commission field hearing at Birmingham, Alabama, on July 29, 2011, on the State of the Municipal Securities Market; MUNICIPALITIES IN DISTRESS? published by Chapman and Cutler LLP which is a 50-State Survey of State Laws Dealing with Financial Emergencies of Local Governments, Rights and Remedies Provided by States to Investors in Financially Distressed Local Government Debt, and State Authorization of Municipalities to File Chapter 9 Bankruptcy, which is available from Chapman and Cutler LLP or on Amazon.com; PRIMER ON MUNICIPAL DEBT ADJUSTMENT, published by Chapman and Cutler LLP, which is available from Chapman and Cutler LLP; "The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress," by James E. Spiotto in the MUNICIPAL FINANCE JOURNAL, Winter/Spring 2013; and "All Eyes on Detroit: What Happens to Unfunded Pension Liabilities When a Municipality Files for Bankruptcy?" at MUNINET GUIDE (August 21, 2013), http:/www.muninetguide.com/print/php ?id=604. The views expressed in this article are solely those of the author.

1. Public Pensions as Contracts 527
2. Protections Afforded by the Contract Clause 528
a. Early Reliance on Police Power to Justify Impairment 528
b. Introduction of the Balancing of Interests..... 530
c. The United States Trust Test..... 531
C. Suggestions for Dealing with the Current Dilemma..... 533
1. Public Pension Modifications Based upon Contract Clause Cases 533
a. The Chapter 9 Experience 534
b. Treatment of Pensions Outside Chapter 9..... 538
2. Critique of the Arizona Supreme Court's Reasoning 542
V. A PROPOSAL FOR SOLVING THIS PROBLEM: A RECOVERY PLAN . 543
A. Everyone Benefits from Reasonable Adjustments to Pension Benefits and Obligations to a Level That Is Sustainable and Affordable..... 543
B. The Current Challenge Facing Municipalities Is Determining the Level of Pension Benefits and Obligations That Is Sustainable and Affordable..... 544
1. Standard for "Feasability" under Chapter 9 544
2. Same Standard for Addressing Financial Obligations in an Out-of-Court Restructuring 545
VI. CONCLUSION: THE PROBLEM IS TOO BIG TO CONTINUE TO IGNORE 547

I. SUMMARY

In this article, I discuss what a financially distressed city, town, or other municipality[1] (collectively a *"municipality"*) must do to survive a financial crisis and how to develop a viable recovery plan. One common point of contention is how to appropriately continue to pay for essential public services, including infrastructure improvements and repairs (collectively *"public services"*), while paying out of current revenues unfunded public employee pension obligations that have built up over many

1. The same principals apply to the individual states as sovereigns. As a result, the question of whether state employee legacy costs for pensions and OPEBs, as defined herein, should have priority over or should be on an equal footing with essential governmental services is also presented to the states.

years (referred to variously as *"public pensions," "pension benefits," "pension obligations"* or *"pension liabilities"*).

A practical approach is critical and must be based on a determination of what pension benefits and obligations are *sustainable and affordable*. Only sustainable and affordable obligations can continue to be paid—only sustainable and affordable benefits can continue to be provided. For the sake of simplicity, other post-employment benefits (*"OPEBs"*) such as retiree health care are not dealt with here as OPEBs raise unique issues of statutory construction and the scope of applicable constitutional protections.[2] Efforts by states to legislatively modify their public pensions frequently are met with litigation. While it is desirable to resolve this conflict consensually, a practical solution that will withstand judicial scrutiny may be more realistic in the current polarized environment facing some

2. Typically, constitutional and statutory provisions more likely focus on retirement payments rather than health care and retirees are viewed as having other viable options under Medicare, 42 U.S.C §§ 1395, and Patient Protection and Affordable Care Act, 42 U.S.C. §§ 18001–121 (2012). In states where the constitutions specifically prohibit the diminishment of pension benefits, courts have taken different approaches with respect to the applicability of such constitutional language to OPEBs. The New York Court of Appeals held that the state constitution, which banned the diminishment or impairment of membership in any pension or retirement system, extended only to benefits directly related to the terms of the retirement annuity. The court held further that retired employees receive subsidies for health insurance premiums "not as a benefit of membership in the retirement system but because he or she was an employee of the State of New York." As a result, a reduction in the contribution to health care premiums did not violate the constitution. *In re* Lipman, 487 N.E 2d 897, 899–900 (N.Y. 1985). *See also* Studier v. MPSERB, 698 N.W.2d 350 (Mich. 2005) (teachers' health care benefits are not "accrued financial benefits" and not protected by the pension clause of the Michigan Constitution). In Hawaii, however, where the constitution stated that "[m]embership in any employees' retirement system of the state or any political subdivision thereof shall be a contractual relationship, the accrued benefits of which shall not be diminished or impaired," the Hawaii high court held that public employees enjoyed a package of benefits under state law that included health insurance. HAW. CONST. art. XVI, § 2. Accordingly, health insurance benefits could not be diminished under the Hawaii constitution. Everson v. State of Hawaii, 228 P.3d 282 (Haw. 2010). Similarly, in Illinois, where the constitution states that "[m]embership in any pension or retirement system of the state . . . shall be an enforceable contractual realtionship, the benefits of which shall not be diminished or impaired," the Illinois Supreme Court held that the clause applied to an Illinois public employer's obligation to contribute to the cost of health care benefits. Kanerva v. Weems, 13 N.E.3d 1228 (Ill. 2014). The Illinois case, which was in the context of a motion to dismiss, can best be read narrowly that the pension clause applies to health care benefits and that the remand to the trial court for further proceedings may lead to the trial court's consideration of whether the proposed reduction in benefits is for the best long term interest of the system or whether the limitation on the ability to pay requires a priority for OPEBs over essential governmental services and the exercise of the police powers of the State for a higher public good as noted herein.

municipalities.

Legally, assessment of a municipality's ability to adjust pension benefits begins with the Contract Clause in the U.S. Constitution[3] (the *"Contract Clause"*) and the mission of state and local governments to provide mandated public services at an acceptable level. Various Supreme Court decisions suggest that if promised pension benefits are unrealistic, it is reasonable to conclude that there is no prohibited impairment under the Contract Clause if such rights are adjusted to what is sustainable and affordable.[4] Such decisions indicate that municipalities cannot be required to honor pension obligations if funding them impairs the ability to provide essential public services.[5] Continually raising taxes is not the answer. Very recently, courts have examined attempts to modify public pensions for the general good.[6] Some recent decisions favor some ability to modify, reasoning that if an unaffordable public pension crowds out the ability to pay for essential public services, it must be modified in order for the municipality to survive.[7] Resolution of these issues currently is under way in various proceedings; these cases will be litigated in the courts for many years to come.

It is critical for all parties working on a municipality's financial recovery to look at current reality rather than second-guess decisions made in past compromises. It is in the best interest of all parties to determine what pension benefits are sustainable and affordable going forward, acknowledging that the resulting adjustment is simply recognition of reality. The relevant issue for discussion is what level of pension benefits and liabilities is realistic in light of other competing demands for the municipality's available funds? If public employees insist upon payment of unsustainable and unaffordable benefits, the resulting cutback of public services may result in a decline in the number of taxpayers available to fund the desired benefits. This process can lead to a death spiral for the municipality. In the long run, an approach to pension benefits based on what is sustainable and affordable will

3. U.S. CONST. art. I, § 10, cl. 1.

4. *See, e.g.*, Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942).

5. *See id.*

6. *See In re* City of Detroit, Mich., 504 B.R. 97 (Bankr. E.D. Mich. 2013); *In re* City of Stockton, Cal., 478 B.R. 8, 14 (Bankr. E.D. Cal. 2012).

7. *Id.*

be more beneficial than any litigation strategy. Any viable plan of debt adjustment must provide an adequate level of public services for the long term. Restructuring that does not provide for adequate public services will be doomed to failure. At the same time, pension benefits should be modified in the least drastic manner available so as much as the municipality can afford to pay will be paid to meet promised pension obligations. Further, public employees must be assured that pension funding obligations, as modified, will be paid so long as they are affordable and sustainable for the municipality going forward.

II. THE CURRENT SITUATION

Municipalities in the United States are not strangers to economic downturns. Since our nation's birth, units of local government have faced six panics, thirty-eight recessions and four depressions, the last being the Great Depression of the 1930s and the Great Recession of 2008. Since 1949, there have been eleven economic downturns. Each downturn (with the exception of the last) has been marked by increased borrowing by state and local governments. This borrowing stimulated a year-over-year increase in the gross domestic product and the percentage of people employed. Notwithstanding this history, few major municipalities have filed for bankruptcy protection.[8]

Recent bankruptcies of Detroit, Michigan; Jefferson County, Alabama; Stockton, California; San Bernardino, California; and

8. Since the advent of Chapter 9 in a constitutionally acceptable form in 1937, there have been 657 Chapter 9s. Most have been small special tax districts, smaller cities and counties. Rarely has any city or county of size filed, and over the last sixty years the largest city and county debtors have been Orange County in 1994, Bridgeport, Connecticut in 1991 (which was dismissed for lack of authority for filing), Jefferson County, Alabama in 2011, Stockton and San Bernardino, California in 2012 and then the largest to date, Detroit, Michigan in 2013. At the same time, the recent numbers on filing of Chapter 9s have indicated a slight downturn from thirteen Chapter 9s in 2011 to twelve in 2012 to eight in 2013. Traditionally, any city of size facing significant financial challenges has chosen to refinance and restructure its debt outside of Chapter 9, such as New York City in 1975, Cleveland, Ohio in 1978, Philadelphia, Pennsylvania in 1991 and Pittsburgh, Pennsylvania in 2000. In fact, of the 283 Chapter 9 filings since 1980, only 53 have been by cities, towns, counties, and villages. Of those 53, at least 24 (45%) never had a plan of debt adjustment confirmed. These statistics demonstrate that, generally, Chapter 9 has been used for small special tax districts, municipal utilities and hospitals, not municipalities of size. *See* JAMES E. SPIOTTO, MUNICIPALITIES IN DISTRESS? HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES (2012), Section II and Appendix A [hereinafter MUNICIPALITIES IN DISTRESS].

Vallejo, California have called into question the long-term sustainability of our municipalities. One pivotal issue raised in these cases is the affordability of maintaining public services at an acceptable level while simultaneously meeting the ever-increasing embedded costs for public pensions.[9] This issue is not merely of academic interest. There is a growing debate as to whether the expenses of essential public services are at odds with a municipality's ability to meet legacy costs, such as pension obligations. Recognizing that there is a limited ability to raise taxes, if public services are lowered or postponed in order for the municipality to meet pension obligations, the resulting exodus of both individual and corporate taxpayers can be fatal to the municipality's future.

Certainly, the issue of modifying public pensions is sensitive. However, if municipalities (including those who seek the protection of Chapter 9) fail to address the competing interests between pension obligations and public services, any restructuring will be futile and merely provide a Band-Aid. Only if the focus is on a recovery plan in which the competing interests, including public pensions, are adjusted to what is sustainable and affordable will the restructuring or bankruptcy process improve the long-term financial health of the municipality. Only an appropriate recovery plan, assuring essential public services are maintained at acceptable levels, will cause economic stimulus. Such economic stimulus can promote business growth and new jobs, allowing the taxpayer base to grow, revenues to increase, and reasonable pension liabilities to be met.[10]

Residents expect certain basic public services (including police and fire protection, education, waste removal, water supply, and street maintenance) to be provided by the municipality in exchange for the taxes the residents pay. Likewise, public employee beneficiaries of municipal pension plans expect to receive agreed-upon pension benefits after retirement.[11] However,

9. *See In re* City of Detroit, Mich., 504 B.R. 97 (Bankr. E.D. Mich. 2013); *In re* City of San Bernardino, Cal., 499 B.R. 776 (Bankr. C.D. Cal. 2013); *In re* City of Stockton, Cal., 478 B.R. 8 (Bankr. E.D. Cal. 2012); *In re* Jefferson County, Ala., 478 B.R. 228 (Bankr. S.D. Ala. 2012).

10. MUNICIPALITIES IN DISTRESS, *supra* note 8, at 34.

11. There also is an intergenerational issue in fully paying ongoing pensions while massive underfunding of pension obligations is allowed to occur. If such underfunding is not addressed, the youngest workers are subject to a cruel game of musical chairs where they have

the proposition that pension benefits are sacred and immutable and cannot be adjusted (this notion, which may be based upon perceived judicial, contractual, statutory, or constitutional interpretation) has pitted public employees against the citizens they serve, the sources of financing necessary to reinvest in the municipality, and unsecured lenders.

I will attempt to provide a new look at how to approach the important competing interests and propose a practical approach to resolving these seemingly unresolvable conflicts. I suggest a possible path forward that could lead to a consensual resolution of the problem or, if necessary, to a solution that will withstand judicial scrutiny and a legal challenge to such pension reform. The focus is on what needs to be done so that a municipality can survive a financial crisis and concurrently develop a viable recovery plan based on what is sustainable and affordable. I will first review the fundamental purposes of local government in the United States and the evolution of retirement benefits for local government workers. In section IV, I will explore the legal protections provided for public pensions, and analyze the leading judicial authorities impacting the ability to modify municipal legacy costs. With the treatment of pension obligations in recent municipal bankruptcies as background, in Section V, I will conclude with suggestions for dealing with pensions, both during a Chapter 9 and before—the last resort to—Chapter 9 is necessary. The observations are designed to encourage the future economic stability of municipalities and the payment of pension obligations that reasonably can be paid.

III. MUNICIPALITIES AND THE EVOLUTION OF PUBLIC PENSIONS

A. Growth of Municipalities and Public Services

Among the reasons for creation of the federal government as articulated in the preamble to the United States Constitution were, the establishment of justice, providing for the common defense, and promoting the general welfare.[12] Many of the same concerns led to the establishment of local municipalities after the

had no seat at the table and enjoy little deference to their long-term interests. Girard Miller, *Pension Reform: Stop Billing the Grandkids*, GOVERNING (Mar. 2012), http://www.governing.com/columns/public-money/col-Pension-Reform-Stop-Billing-the-Grandkids.html.

12. U.S. CONST. pmbl.

Revolutionary War when state governments, acting as co-sovereigns with the federal government, began issuing municipal charters.[13] With early American roots in principles of local self-government, municipalities developed to exert a dominating influence upon the quality of life of United States citizens.[14]

Today, municipalities function pursuant to applicable state law to serve their citizens by providing public services perceived to be necessary for a civilized society. As a result, it is up to states and municipalities to provide the basic building blocks of society; specifically, to provide essential governmental services at an acceptable level in order to foster a business climate that will stimulate new jobs and growth of the local economy and population. This, in turn, will provide the necessary tax dollars to fund governmental services. Constant vigilance is required to ensure that public services are at an acceptable level.[15]

The public services demanded of and provided by municipalities have expanded tremendously over the years.[16]

13. MCQUILLIN, THE LAW OF MUNICIPAL CORPORATIONS, §1.20 (3d ed. 2013).

14. *Id.* §1.40.

15. Our state and local governments have built the world's largest infrastructure for the world's largest economy. *See* MUNICIPALITIES IN DISTRESS, *supra* note 8, at 7. The United States contains the most extensive and sophisticated public works system in the world including 4,092,730 miles of roadways, 603,259 bridges, 1,100 local bus systems, 19,750 airports (of which 5,178 are for public use), 25,320 miles of inland and intercoastal waterways, almost 84,000 dams, more than 2 million miles of pipe in water supply systems and over 15,000 wastewater treatment plants provided mostly by municipalities and political subdivisions of a state. BUREAU OF TRANSP. STAT., TBL. 1-1: SYSTEM MILEAGE WITHIN THE UNITED STATES, http://www.rita.dot.gov/bts/sites/rita.dot.gov.bts/files/publications/national_transportation_statistics/html/table_01_01.html; CorpsMap, National Inventory of Dams, http://geo.usace.army.mil/pgis/f?p=397:1:0; EPA, 2006 COMMUNITY WATER SYSTEM SURVEY REPORT, http://water.epa.gov/infrastructure/drinkingwater/pws/upload/cwssreportvolumeI2006.pdf. The American Society of Civil Engineers, in its 2013 Report, estimates the cost to maintain this infrastructure at a passable level will be $3.6 trillion by 2020 or about four times the annual tax revenues for all state and local governments. AM. SOC'Y OF CIVIL ENGINEERS, 2013 REPORT CARD FOR AMERICA'S INFRASTRUCTURE, http://www.infrastructurereportcard.org/a/documents/2013-Report-Card.pdf.

16. The current list of services and infrastructure may encompass air pollution prevention, airport establishment and maintenance, bridge building and maintenance, building code enforcement, civil defense, fire prevention and firefighting, garbage and waste disposal, health regulations, hospital care, housing, law enforcement, library maintenance, parks, planned city development, police protection, provision of public utilities and recreational facilities, sewerage, street lighting and traffic, schools, streets, roads and highways, traffic control, water supply, water pollution prevention, welfare for the indigent and handicapped and zoning regulations. MCQUILLIN, *supra* note 13, at §1.68.

Residents understandably expect maintenance of such local public services at an acceptable level to meet basic human needs (generally including sanitation, water, streets, schools, food inspection, fire department, police, ambulance, health, and transportation). While satisfactory provisions are expected to lead to a content citizen base, collateral benefits are also expected, *i.e.,* the growth of business, creation of good jobs in the service and construction industries, a healthy local economy, and new taxpayers.[17]

Infrastructure spending by the state or municipality generates significant economic returns. In the short run, a dollar spent on infrastructure construction produces roughly double the initial spending in economic output.[18] In the long run, over a twenty year period, generalized "public investment" generates in aggregate $3.21 of economic activity per $1.00 spent.[19] In addition, infrastructure spending substantially increases ultimate tax revenues. For example, over 20 years, investing $1.00 in sewer systems and water infrastructure returns a full $2.03 in tax revenue to federal and state/local governments, of which $1.35 specifically accrues at the federal level.

B. Growth of Public Pensions

As municipalities have matured and become providers of basic public services, the compensation provided to public employees has grown to include pensions. Public pensions differ from the pension systems common in the private sector.[20]

17. *See* PAUL BAIROCH, CITIES AND ECONOMIC DEVELOPMENT (1988); BRENDAN O'FLAHERTY, CITY ECONOMICS (2005).

18. ISABELLE COHEN, THOMAS FREILING & ERIC ROBERSON, THE ECONOMIC IMPACT AND FINANCING OF INFRASTUCTURE SPENDING 1 (2012), *available at* http://www.wm.edu/as/publicpolicy/documents/prs/aed.pdf.

19. *Id.*

20. Generally, public pension funds are defined benefit plans where the risk of loss and market volatility is on the public employer. On the other hand, private corporations generally provide (if any) a 401k defined contribution plan where a fixed sum is paid by the employer with no risk of loss or market volatility. BARBARA D. BOVBJERG, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT PENSION PLANS: CURRENT STRUCTURE AND FUNDED STATUS 3 (2008); Robert Novy-Marx & Joshua D. Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FIN. 1211, 1219 (2011). Some have argued that the payment of higher pension benefits to public workers compared to those in the private sector is to compensate the public worker for a lower salary. However, research statistics indicate the opposite. Namely, as of March 20, 2014, the average

The health of public pension funds depends on contributions from public employees, investment earnings, and ever-increasing contributions from public employers. If a public employer contributes less than the amount actuarially required to meet promised benefits or assumes an overly optimistic return on its investments, the pension fund is adversely affected or underfunded. While experts may debate whether a defined benefit plan (*"DBP"*) or defined contribution plan (*"DCP"*) is the best form of pension fund and the exact amount of local government pension underfunding in the United States, it is beyond dispute that the cost of public pensions generally is growing faster than public employer revenues and increasingly crowds out other necessary budget items. This reality threatens public safety, health care, education, and infrastructure funding, as well as aid to the vulnerable.[21]

A U.S. Senate Committee Report estimated, in 2012, that the public pension debt of state and local governments was nearly $4 trillion.[22] In 2009, Professor Joshua Rauh of the Kellogg School of Management, Northwestern University, estimated that municipal pension plans in the United States were carrying $574 billion in off-balance-sheet debt in the form of unfunded pension obligations.[23]

A 2013 Report issued by The Pew Charitable Trusts noted that nearly half the cities examined were not paying their full

private worker had a salary or wages of $21.96 per hour plus benefits (including retirement) of $9.97 per hour. On the other hand, during the same time period, the average public worker (state and local government) had a wage or salary of $27.75 per hour plus benefits of $15.36 per hour. Total compensation for the average private worker (taxpayer) is $31.93 per hour compared to $43.10 per hour for the average public worker. In short, total compensation for the average public worker is about 140% of what the average private worker receives. Please note that averages show trends but still are generalizations, and there is a difference in type of jobs and comparable compensation between private and public workers, such as about two-thirds of state and local workers are teachers and command an appropriate heightened salary given their position. See Bureau of Labor Statistics, U.S. Department of Labor News Release, 14-1075 (June 11, 2014), http://www.bls.gov/news.release/archives/ecec_06112014.htm.

21. *See* RICHARD RAVITCH ET AL., REPORT OF THE STATE BUDGET CRISIS TASK FORCE 10 (2014).

22. U.S SENATE COMM. ON FIN., STATE AND LOCAL GOVERNMENT DEFINED BENEFIT PENSION PLANS: THE PENSION DEBT CRISIS THAT THREATENS AMERICA 1 (2012).

23. Joshua Rauh & Robert Novy-Marx, *The Crisis in Local Government Pensions in the United States, in* GROWING OLD: PAYING FOR RETIREMENT AND INSTITUTIONAL MONEY MANAGEMENT AFTER THE FINANCIAL CRISIS 49 (Yasuyuki Fuchita, Richard J. Herring & Robert Litan eds., Brookings Institution 2011), *available at* http://web.stanford.edu/~rauh/research/NMRLocal20101011.pdf.

recommended annual contributions to the funds meant to pay for pension benefits, putting off the costs for future taxpayers to deal with.[24] The Pew Report concluded that future dollars available for day-to-day operating functions and services on which citizens rely will be squeezed as cities are forced to make up the difference for pensions and OPEBs.[25] Pew cites an alarming trend, stating that cities faced with persistent budget gaps are even being forced to reduce expenditures for public safety.[26]

While time can be spent debating the investment strategies utilized, the return on investments obtained, and questioning the actual level of underfunding of public pension debt, there is no question that the problem is of a size that can no longer be ignored. Public employee costs generally are growing faster than revenues and, at present, are crowding out other necessary budget items. Currently, massive unfunded pension obligations threaten the funding for essential local public services.

If municipalities must make excessive future payments to fund pensions from current revenues, some municipalities may face insolvency. This can impact the retention of employees, the payment of pension benefits, and the delivery of necessary public services.[27] This phenomenon undoubtedly will lead to a reduction in public services in order to make such payments. This could lead to greater taxpayer dissatisfaction and political instability.[28] Failure to fund essential public services inevitably leads to a death spiral. Local governments are forced to raise taxes and to reduce services in order to balance their budgets given the increased cost of pensions outpacing any increase in revenues. Specifically, this motivates more corporate and individual citizens to leave and reduces revenues paid into the municipality even further. Thereafter, there are fewer dollars to pay employees and retirees and for public services. So comes another wave of raising taxes

24. THE PEW CHARITABLE TRUSTS, AMERICA'S BIG CITIES IN VOLATILE TIMES MEETING FISCAL CHALLENGES AND PREPARING FOR THE FUTURE 20 (2013), *available at* http://www.pewtrusts.org/~/media/Assets/2013/11/11/AmericasBigCitiesinVolatileTimes.pdf.

25. *Id.* at 17–19.

26. *Id.* at 17.

27. *See* Lynn M. Brimer, Meredith E. Taunt & Mallory A. Field, *Measuring Service Delivery Insolvency in Chapter 9*, 2 XXXIII ABI J. 26 (2014), *available at* http://www.stroblandsharp.com/wp-content/uploads/2014/02/ABI-bankruptcy-feature-2-14-brimer-taunt-field.pdf.

28. Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 7 (2013).

and cutting public services accompanied by corporate and individual citizens fleeing the municipality, resulting in further reduction of revenues. While a number of states and municipalities are wrestling with this problem, resolution is complicated.[29]

C. Description of the Current Dilemma

Many public pension funds are critically underfunded. Municipal obligations to more fully fund such pension obligations from current revenues are putting stress on funding for essential public services. Consequently, municipalities and their advisors are considering whether public pension obligations can be modified in order to make them sustainable and affordable, either outside of bankruptcy or within a Chapter 9. However, before practical solutions to the public pension funding dilemma can be fashioned, the legal issues raised by modification of public pension benefits must be explored.

IV. LEGAL PROTECTIONS PROVIDED FOR PUBLIC PENSIONS

A. Historical Development of the Law

The accepted view of the nature of public pension benefits has evolved dramatically over the years. In the first part of the twentieth century, the consensus among courts examining public pension benefits was that such benefits were entitled to virtually no protection. Pensions were deemed to be mere gratuities from the government that could be amended or withdrawn at any time. Pensions were treated as pay-as-you-go obligations that would be paid if funds were available and if the local governments were willing.

29. Between 2010 and 2012, over forty states addressed pension reform (eight in 2012, thirty-two in 2011 and 21 in 2010). Between 2009 and 2011, twenty-eight states increased employer contributions and seven states increased employee contributions for new hires. Also between 2009 and 2011, twenty-eight states increased the retirement age and service requirement and eighteen reduced post-retirement benefit increases such as cost of living adjustments (COLA). Illinois, Maine, Minnesota, New Jersey, Rhode Island, South Dakota and Colorado have enacted legislation and in some cases litigated and won COLA reform and adjustments. San Diego, San Jose and other cities have imposed pension reform for new hires and current employees to reduce cost and expense. JAMES E. SPIOTTO, THE UNFUNDED PENSION OBLIGATION CRISIS: IS CHAPTER 9 BANKRUPTCY THE ULTIMATE REMEDY? ARE THERE BETTER RESOLUTION MECHANISMS? (2014). However, some states and municipalities have not even begun to address these issues.

Understandably, workers required more protection, and the view that a pension is a gift has been abandoned by most states. The rationale for the abandonment may include political or policy grounds or even state laws prohibiting making a gift to an individual.[30] The advent of public employee unions that negotiated defined benefit plans for their members played no small part in the development of the public pensions that exist today.[31]

B. Current State of the Law

1. Public Pensions as Contracts

Currently, it is widely accepted that public pensions are in the nature of a contract and therefore entitled to the protection of the Contract Clause.[32] Some states have adopted constitutional provisions specifically protecting public pensions from impairment or modification.[33] Certain state courts have held that statutes establishing public pensions have created contracts with the public employees that prohibit any detrimental changes to the benefits provided to current employees. Some cases have held that even prospective modification is precluded.[34]

As noted, a few states (*e.g.,* Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, and New York) have specific state

30. Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617 (2010), *available at* http://ssrn.com/abstract=1573864. Only Texas and Indiana retain the gratuity position.

31. As noted, "the burden is placed on the employer to contribute funds on an actuarially sound basis." Paul M. Secunda, *Constitutional Contracts Clause Challenges in Public Pension Litigation*, 28 HOFSTRA LAB. & EMP. L.J. 263, 268 (2011); *see* Stephen F. Befort, *Unilateral Alteration of Public Sector Collective Bargaining Agreements and the Contract Clause*, 59 BUFF. L. REV. 1 (2011).

32. Monahan, *supra* note 30, at 7.

33. 16A CJS *Constitutional Law* § 466 (2014). *See, e.g.*, ILL. CONST. art. XIII, § 5 ("[m]embership in any pension or retirement system of the state, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."); MICH. CONST. art. IX, § 24 ("The accrued financial benefits of each pension plan and retirement system of the state and its political subdivision shall be a contractual obligation thereof which shall not be diminished or impaired thereby."); N.Y. CONST. art. V, § 7 ("[M]embership in any pension or retirement system of the state or a local division thereof shall be a contractual relationship, the benefits of which shall not be diminished or impaired.").

34. Courts in California and in twelve other states have adopted the view that state retirement statutes create contracts as of the first day of employment. *See* Amy B. Monahan, *Statutes as Contracts? The "California Rule" and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1032 (2012).

constitutional provisions prohibiting impairment or diminishment of public employee pensions, although the provisions differ with respect to the protection afforded future benefits.[35] Nine other states (*e.g.*, California) have general constitutional prohibitions against impairment of contracts.[36] The remaining states, with the exception of those retaining the gratuity analysis, generally have state statutes or case law prohibiting some forms of impairment of public pensions.[37] Importantly, absent from the legislative history supporting the state constitutional or statutory provisions is any notion of the intent to elevate pension obligations as super-priority claims over all other obligations of the local government.

2. Protections Afforded by the Contract Clause

Pensions deal with the payment of a sum in the future from funds to be levied and collected in the future and are best dealt with as a contractual right to a future payment since no property is pledged or dedicated to payment. Any assessment of the ability to adjust the pension benefits of public employees begins with the Contract Clause, which provides that "[n]o [s]tate shall . . . pass any . . . [l]aw impairing the [o]bligation of [c]ontracts."[38] States that have enacted specific constitutional provisions dealing with contracts have, in large part, included a similar concept. The current financial difficulties facing municipalities have renewed interest in the scope of protections afforded pension benefits by this language. Specifically, the question currently under discussion is whether public pension obligations can be adjusted, modified, or eliminated so that a municipality can fulfill its duty of providing essential public services at an acceptable level for its citizens?

a. Early Reliance on Police Power to Justify Impairment

During the nineteenth century, numerous court cases successfully invoked the Contract Clause. However, it has been observed that the importance of the Contract Clause steadily diminished in constitutional law of the United States during the

35. *Id.*

36. *Id.* at 1082.

37. *See* ALICIA H. MUNNELL & LAURA QUINBY, CTR. FOR RET. RESEARCH AT BOS. COLLEGE, LEGAL CONSTRAINTS ON CHANGES IN STATE AND LOCAL PENSIONS 1–3 (2012), *available at* http://crr.bc.edu/briefs/legal-constraints-on-changes-in-state-and-local-pensions/.

38. U.S. CONST. art. 1, § 10, cl. 1.

period from 1890 to 1977.[39] Significant in that de-emphasis was a line of United States Supreme Court cases holding that the states may not bargain or contract away certain basic inalienable governmental powers (such as the police power) and that states' attempts to do so are void.[40] Hence, attempts do not create contractual obligations within the meaning of the Contract Clause.[41]

An early case holding that the Contract Clause does not require a state to adhere to a contract that surrenders an essential governmental power was *Stone v. Mississippi*.[42] In that case, the state had granted a charter to a lottery company for twenty-five years but subsequently adopted a constitutional provision banning lotteries.[43] In upholding the constitutional ban, the court noted that supervision by the state of this issue needed to be dealt with "as the special exigencies of the moment require."[44] This limitation on the Contract Clause thus found its source in the police power, *i.e.,* in the capacity of the states to regulate behavior and enforce order within their territory in the interest of the health, safety, morals, and general welfare of the inhabitants.

In another early case, parties who had contracted with the state for clear passage through a creek objected to subsequent legislation providing for the installation of a dam across it.[45] The Supreme Court noted that police power is *paramount* to any contractual right and the principle against the impairment of contracts does not prevent the state from exercising such powers as are vested in it for the promotion of the common good.[46]

Similarly in *Chicago and Alton Railroad Co. v. Tranbarger*, the plaintiff argued that subsequent legislation requiring railroads to construct ditches and drains interfered with its operation.[47] The Supreme Court found that no person has a vested right in any policy of legislation entitling him to insist that it shall remain

39. Bernard Schwartz, *Old Wine in New Bottles? The Renaissance of the Contract Clause*, 1979 SUP. CT. REV. 95, 98 (1979).

40. *Id.* at 99.

41. *Id.* at 100.

42. Stone v. Mississippi, 101 U.S. 814 (1879).

43. *Id.* at 817–19.

44. *Id.* at 819.

45. Manigault v. Springs, 199 U.S. 473, 473 (1905).

46. *Id.* at 480.

47. Chicago & Alton R.R. Co. v. Tranbarger, 238 U.S. 67, 74 (1915).

unchanged, nor is any such right implied in any express contract.[48] There is an implied reservation of rights that cannot be abrogated, surrendered or bargained away by contractual provisions.[49]

In an extension of this view, the Supreme Court in *Stephenson v. Binford* rejected the complaint of private carriers to provisions of highway legislation; it noted that contracts are to be regarded as having been made subject to the future exercise of the constitutional police power of the state.[50]

b. Introduction of the Balancing of Interests

Over time, the Supreme Court's stated reasoning in determining the propriety of alleged impairment has become more nuanced. In *Homebuilding & Loan Ass'n v. Blaisdell*, the Minnesota Mortgage Moratorium Law (which provided that, during a declared emergency, relief could be had with respect to mortgage foreclosures and execution sales) was challenged as being repugnant to the Contract Clause.[51] The Supreme Court upheld the statute as a valid exercise of the police power, noting that the constitutional protection against the abrogation of contracts was qualified by the authority the state possesses to safeguard the vital interests of its people and that the legislature cannot bargain away the public health or the public morals.[52] Further, the economic interests of the state may justify the exercise of its continuing and dominant protective power notwithstanding any interference with contracts.[53] Importantly for this analysis, the *Blaisdell* court noted that there needs to be a rational compromise between individual rights and the public welfare.[54] It articulated the conditions that justify interference with contractual rights, including: (1) an emergency is present, (2) the legislation is addressed to a legitimate end, (3) the relief afforded is of a character appropriate to the emergency and (4) the conditions do not appear to be unreasonable.[55]

48. *Id.* at 76.
49. *See* Phillips Petroleum Co. v. Jenkins, 297 U.S. 629 (1936).
50. Stephenson v. Binford, 287 U.S. 251, 276 (1932).
51. Homebuilding & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).
52. *Id.* at 437.
53. *Id.*
54. *Id.* at 437–38.
55. *Id.* at 444.

The Supreme Court has already applied these principles in an instance of municipal distress. In *Faitoute Iron & Steel Co. v. City of Asbury Park, N.J.*, the Supreme Court upheld a challenge by the unsecured bondholders of Asbury Park to a New Jersey law that provided for a plan of adjustment in which they received refunding bonds that represented a haircut from their original securities.[56] The Supreme Court specifically rejected the bondholders' claims that the original bonds "constituted contracts, the obligation of which was impaired by the denial of their right to recovery thereon and by the transmutation without their consent into the securities authorized by the plan of adjustment."[57] The Supreme Court also rejected the view that the Contract Clause barred "the only proven way for sure payment of unsecured municipal obligations."[58] According to the *Asbury Park* court, the state retains police power for the maintenance of its political subdivisions and for the protection of all creditors.[59] The court specifically noted that its holding did not apply to secured claims, claims secured by property (revenues) dedicated or pledged for the obligation by statute or contract such as revenue bonds.[60] Further, the court commented that, in view of the slump of the collections from the exercise of the city's taxing power, the original bonds had little value.[61]

The court in *El Paso v. Simmons* cited these cases when summarizing that not every modification of a contractual promise impairs the obligation of a contract under the Contract Clause.[62] The court cited *Blaisdell* for the proposition that the prohibition against impairment of contract "is not . . . absolute . . . and is not to be read with literal exactness like a mathematical formula."[63]

c. The United States Trust Test

Many view *United States Trust Co. v. New Jersey*[64] as the

56. Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942).
57. *Id.* at 509.
58. *Id.* at 512–13.
59. *Id.* at 513–14
60. *Id.* at 516.
61. *Id.* at 513.
62. El Paso v. Simmons, 379 U.S. 497, 507 (1965).
63. *Id.* at 509.
64. U.S. Trust Co. v. New Jersey, 431 U.S. 1 (1977).

case in which the Supreme Court refined its analysis of the ability to impair public contracts. The trustee and holder of port authority bonds brought suit claiming that a New Jersey statute impaired the obligation of the state's contract with bondholders in violation of the Contract Clause.[65] Citing *Blaisdell*, the Supreme Court confirmed that the Contract Clause was not absolute.[66] However, the court noted that the New Jersey statute, in fact, totally eliminated an important security provision for the bonds.[67] The court specified that, when a state impairs the obligations of its own contract, the "reserved-powers doctrine has a different basis."[68] Impairment may be constitutional if it is reasonable and necessary to serve an important public purpose.[69] However, in the case of the state impairing its own contract, complete deference to the legislative assessment of reasonableness and necessity is not always appropriate because the state's self-interest is at stake.[70] The court found that the *extent* of impairment is a relevant factor in determining its reasonableness.[71] The court then distinguished the case from *Asbury Park*, characterizing that case as the only time in the century that alteration of a municipal bond contract had been allowed, and noting that the rights interfered with in *Asbury Park* were only theoretical because the taxes could not have been raised enough to pay those original obligations.[72] According to the *U.S. Trust* court, that case involved a more serious impairment because real rights of the bondholders were affected.[73] The court found that the total repeal of the security covenant was not necessary and could not be sustained.[74]

The following year, in *Allied Structural Steel Co. v. Spannaus*, the Supreme Court quoted *U.S. Trust* for the proposition that the Contract Clause does not obliterate the police power of the state but does impose some limits upon the power of the state to

65. *Id.* at 3.
66. *Id.* at 21.
67. *Id.* at 19.
68. *Id.* at 23.
69. *Id.*
70. *Id.* at 24.
71. *Id.* at 27.
72. *Id.* at 27–28.
73. *Id.* at 28.
74. *Id.*

abridge existing contractual relationships.[75] Legislation adjusting the rights and responsibilities of contracting parties must be based upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption.[76] Noting that while the language of the Contract Clause appeared absolute, the Supreme Court reiterated that "literalism in the construction of the Contract Clause . . . would make it destructive of the public interest by depriving the state of its prerogative of self-protection."[77] The Supreme Court reversed the three-judge court and held that a Minnesota law, which retroactively modified compensation with an employer to the detriment of the employer, could not be sustained because (i) the effect on the contractual obligation was severe and "impose[d] a completely unexpected liability" on the employer "in disabling amounts" and (ii) there was "no showing that the severe disruption of contractual expectations was necessary to meet an important general social problem."[78] According to the court, the Minnesota law could hardly be characterized as one enacted to protect a broad societal interest rather than a narrow class.[79]

C. Suggestions for Dealing with the Current Dilemma

1. Public Pension Modifications Based upon Contract Clause Cases

A careful review of the foregoing cases provides guidance as to possible solutions to the current public pension crisis.[80] Pensions involve the payment of a sum of money in the future from funds to be levied and collected in the future. Past legislation cannot restrict funding for pension obligations, especially when there are competing needs for the same funds to pay for essential government services such as health, safety, or welfare. Such obligations cannot and should not be perceived as a property right.

75. Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978).

76. *See id.* at 242.

77. *Id.* at 240.

78. *Id.* at 247.

79. *Id.* at 248.

80. *See* Beermann, *supra* note 28, at 63–67 (discussing how the takings clause protecting property rights without just compensation adds little to the argument against adjusting pensions where necessary and arguing that generally property rights are likely to be only those that are protected by the Contract Clause.).

Proponents of public pension plans should welcome the rule that any contractual impairment must be reasonable and based on an important public purpose as an indication that there will not be whole-cloth jettisoning of pension rights. The distinction drawn in the *U.S. Trust Co.* case between the illusory rights of the *Asbury Park* bondholders and the substantial rights of the *U.S. Trust Co.* holders is particularly relevant. As previously mentioned, the Supreme Court dismissed the argument that an important security provision for the *Asbury Park* bondholders had been impaired because those rights were only theoretical since taxes could not be raised sufficient to meet the obligations.[81] Accordingly, there was no interference with a property right.[82] Such analysis is especially applicable to unaffordable and unsustainable public pension plans. If promised pension benefits are unrealistic and unattainable, then there is no prohibited impairment if such rights are adjusted to what is sustainable and affordable.

Courts that have grappled with the issue have recognized that, for municipalities to survive, where unaffordable pension benefits crowd out essential governmental services and needed infra-structure, those pension programs must be modified. Very recently, courts both within the Chapter 9 context and outside of bankruptcy have examined the ability of courts to modify public pension provisions for the general good.

a. The Chapter 9 Experience

Recent municipal bankruptcies have fueled a growing public debate as to the long-term ability of local governments to provide essential public services. Attention has focused on the seemingly insurmountable problems created by the ever-increasing costs of public employees' salaries, benefits, unfunded pensions, and OPEB liabilities in light of the very limited ability municipalities have to raise taxes. Public concern is increasing that reducing or postponing public services in favor of funding pension obligations may severely compromise the municipalities' future if it results in an exodus of both individual and corporate taxpayers.

The City of Vallejo, California, faced a dramatic decline in revenues coupled with rising public safety costs and overwhelming

81. Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 515–17 (1942).

82. In other words, you cannot have a property right to receive payment where funds are not realistically going to be available.

obligations to its employees, which led to a Chapter 9 filing.[83] In that Chapter 9 case, Vallejo modified its collective bargaining agreements and saved substantial sums otherwise owed to current employees.[84] Public safety expenditures were cut. Vallejo also reduced retiree healthcare obligations.[85] The pension obligations to existing retirees were not modified or addressed. Two years after bankruptcy, pension obligations (a major expense that created the problem) have not been addressed, and Vallejo still is mired in pension debt, calling into question the viability of the plan of adjustment in that case.[86] Likewise, in the recent *Jefferson County* bankruptcy, while the county approved a plan of adjustment, the county's significant problem of reduction in government services was not dealt with.[87]

In *San Bernardino* and *Stockton*, both filed in 2012, the tension between public employees and representatives of public debt initially played out in disputes over the eligibility of the debtors to file for Chapter 9.[88] Both cases ultimately resulted in decisions affirming the validity of the petitions. As a result, the next battle looming in those cases is whether the cities can propose and confirm a viable plan that would impair the rights of the California Public Employees Retirement System (*"CalPERS"*). The two cities appear to be taking different approaches; with Stockton keeping current on all payments to the pension fund while San Bernardino, which had halted bi-weekly payments and failed to make timely payments to CalPERS, desires to achieve an adjustment of the CalPERS debt in the Chapter 9 proceeding.[89]

The court in the *Stockton* case has examined the issue of the

83. *See In re* City of Vallejo, Cal., 408 B.R. 280 (B.A.P. 9th Cir. 2009).

84. *Id.* at 287.

85. *Id.*

86. Mike Shedlock, *Vallejo Faces 2nd Bankruptcy Because They Didn't Restructure Pensions*, UNION WATCH (Oct. 2, 2013), http://unionwatch.org/vallejo-faces-2nd-bankruptcy-because-they-didnt-restructure-pensions/. Vallejo has a budget deficit for 2014 and a projected budget deficit of $9 million for 2015. Alan Shapiro, *Back to the (Bankruptcy) Drawing Board for California Town*, FOX BUS. NEWS, Feb. 21, 2014, http://www.foxbusiness.com/econo my-policy/2014/02/21/back-to-bankruptcy-drawing-board-for-california-towns/.

87. *See* Disclosure Statement Regarding Chapter 9 Plan of Adjustment for Jefferson County Alabama at 24, *In re* Jefferson County, Ala., 474 B.R. 228 (Bankr. S.D. Ala. 2012), *available at* http://www.alnb.uscourts.gov/sites/default/files/natinterestcases/jca_1977_01.pdf.

88. *In re* City of San Bernardino, Cal., 499 B.R. 776 (Bankr. C.D. Cal. 2013); *In re* City of Stockton, Cal., 478 B.R. 8 (Bankr. E.D. Cal. 2012).

89. *Stockton*, 478 B.R. at 8; *San Bernardino*, 499 B.R. at 776.

impairment of the retirees' contract on a preliminary basis and noted that, while the "Contracts [sic] Clause is a key navigational star in the firmament of our constitution and economic universe, it is subject to being eclipsed by the Bankruptcy Clause: 'The Congress shall have power to … establish … uniform Laws on the subject of Bankruptcies throughout the United States.' U.S. CONST., article 1, § 8, clause 4."[90] Rather than analyzing the Supreme Court precedent that supports a state's impairment of a contract for the public good, the *Stockton* court focused on the nature of bankruptcy as a land of broken promises and impaired contracts. Significantly, the court notes, "the Contract Clause bans a *state* from making a law impairing the obligations of a contract; it does not ban *Congress* from making a law impairing the obligation of a contract."[91] According to the *Stockton* judge, "[t]his asymmetry is no accident. The Bankruptcy Clause necessarily authorizes Congress to make laws that would impair contracts. *Sturges v. Crowninshield*, 17 U.S. (4WHEAT.) 122, 191 (1819)."[92] According to the *Stockton* court, that included even retired city employees' health benefits. The judge ruled that "[t]he federal bankruptcy power also, by operation of the Supremacy Clause, trumps the similar contracts clause in the California state constitution."[93]

In the *Detroit, Michigan* bankruptcy, in connection with the eligibility objections filed in relation to the Chapter 9 petition, the

90. *Stockton*, 478 B.R. at 14.

91. *Id.* at 16.

92. *Id.* at 15.

93. *Id.* at 16. The bankruptcy court in Stockton has stated in open court that, even if Stockton enters into a consensual plan with all its creditors, the court may rule pension debts to be subject to reduction in a Chapter 9. This could result in an appellate ruling on the issue. Dale Kasler, *Judge Suggests Stockton Worker Pensions Could be Reduced in City's Bankruptcy Case*, SACRAMENTO BEE, July 8, 2014, http://www.sacbee/2014/07/08/6542 362/judge-suggests-stockton-worker.html; *see* Moran v. City of Central Falls, 475 B.R. 323 (Bankr. D. R.I. 2012) (affirming the rejection in Chapter 9 of an employment agreement between the city and a police officer. The plan in that case provided for the restructuring and reduction of pension claims). *See* Plan for the Adjustment of Debts of the City of Central Falls, Rhode Island, *In re* City of Cent. Falls, R.I., 468 B.R. 36 (Bankr. D.R.I. 2012). Recently, Rhode Island officials and a federal mediation agency reached an agreement to settle lawsuits by public sector unions challenging Rhode Island's 2011 law that overhauled state pension benefits. The settlement tweaked the formula for COLA adjustments and permitted employees with more than 20 years of service to shift back into a defined benefit plan. *See* Paul Burton, *Rhode Island Strikes Pension Settlement*, THE BOND BUYER, Feb. 14, 2014, http://www.bo ndbuyer.com/issues/123 _32/rhode-island-strikes-pension-settlement-1059911-1.html.

court dealt with the issue of public pensions.[94] The bankruptcy court preliminarily stated that the court recognized and appreciated the importance of the pension rights of city employees and how the city would ultimately propose to treat those rights.[95] In a subsequent order of December 5, 2013 regarding eligibility, the bankruptcy court ruled that the Tenth Amendment to the United States Constitution does not prohibit the impairment of contract rights that are otherwise protected by the state constitution since such provisions impose no constraint on the bankruptcy process.[96] Importantly, the court ruled that "nothing distinguishes pension debt in a municipal bankruptcy case from any other debt."[97] According to the court, "[i]f the Tenth Amendment prohibit[ed] the impairment of pension benefits in [the *Detroit*] case, then it would also prohibit the adjustment of any other debt . . . ."[98] The court held that, under the Michigan Constitution pension rights are contractual rights, and therefore are subject to impairment in a federal bankruptcy proceeding.[99] Nevertheless, the bankruptcy court emphasized that "no one should interpret this holding . . . to mean the [c]ourt [would] necessarily confirm any plan of adjustment that impairs pensions."[100] "The [c]ourt emphasize[d] that it [would] not lightly or casually exercise the power under federal bankruptcy law to impair pensions."[101] "Before the [c]ourt confirms any plan that the city submits, the [c]ourt must find that the plan fully meets the requirements of 11 U.S.C. §943(b) and the other applicable provisions of the Bankruptcy Code."[102] "Together these provisions of law demand the [c]ourt's judicious legal and equitable consideration of the interests of the [c]ity and all of its creditors as well as laws of the State of Michigan."[103]

94. Order Regarding Eligibility Objections, Notices of Hearings and Certifications Pursuant to 28 USC § 2403(a) and (b), *In re* City of Detroit, Mich., 504 B.R. 97 (Bankr. E.D. Mich. 2013).

95. *Id.*

96. *See* Opinion Regarding Eligibility at 74, *In re* City of Detroit, Mich., No. 13-53846 (Bankr. E.D. Mich. Dec. 5, 2013), *available at* http://www.freep.com/assets/freep/pdf/C4216000125.PDF.

97. *Id.*

98. *Id.*

99. *Id.* at 80.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.* As of the writing of this article, Detroit had filed a Second Amended Chapter 9

b.Treatment of Pensions Outside Chapter 9

Attempts also have been made to modify pension rights outside of Chapter 9 proceedings. The Supreme Court of Puerto Rico has approved legislation modifying pension rights. Moreover, in the State of Illinois, legislation to amend the Illinois Pension Code, signed into law on December 5, 2013, is subject to a number of lawsuits currently making their way through the Illinois state courts. As previously noted, Rhode Island recently agreed to settle lawsuits brought by state workers challenging the 2011 legislation reforming the public pension system.[104] Labor's court challenge to the constitutionality of this reform now appears headed for trial given the breakdown in the mediation resulting from the police union rejection of a proposed settlement. It is always possible that mediation efforts could resume.

Interestingly, the Puerto Rican Constitution contains language similar to that in California, explicitly stating, "No laws impairing the obligations of contract shall be enacted."[105] When the Puerto Rican government passed legislation reforming the Commonwealth's pension system, the new legislation was challenged on the basis of the Puerto Rican constitutional provision. Subsequently,

Plan for the Adjustment of Debts of the City of Detroit. Second Amended Chapter 9 Plan for the Adjustment of Debts, *In re* City of Detroit, Mich., No. 13-53846 (Bankr. E.D. Mich. Apr. 16, 2014), *available at* http://www.detroitmi.gov/Portals/0/docs/EM/Bankruptcy%20Information/Second%20Amended%20Plan%20for%20the%20Adjustment%20of%20Debts%20of%20the%20City%20of%20Detroit.pdf. This reflected a tentative pact with the city's retired police and firefighters in which pensions for retired police and fire workers would not be decreased but would take a 55% reduction in annual cost of living adjustments. Pensions for general retirees would be reduced by 4.5% with a freeze of cost of living increases. The open question is whether a plan of adjustment based upon such settlements will be feasible.

104. *See* Burton, *supra* note 93. A number of other states have enacted legislation to modify their pension systems, and those efforts typically have been met with litigation. *See* Stuart Buck, *Pension Litigation Summary*, LAURA AND JOHN ARNOLD FOUNDATION 3 (Apr. 2013), http://www.arnoldfoundation.org/sites/default/files/pdf/Pension%20Litigation%20Summary%204.9.13.pdf. A number of decisions have upheld amendments to existing pension plans. *See, e.g.*, McInerney v. Pub. Employees' Ret. Ass'n., 976 P.2d 348, 352 (Colo. App. 1999) (holding that a pension plan can be changed so long as any adverse modification is balanced by a corresponding change of a beneficial nature, a change that is actuarially necessary or a change that strengthens or improves the pension plan); Madden v. Contributory Ret. Appeal Bd., 729 N.E.2d 1095 (Mass. 2000) (modifying state retirement schemes are permitted so long as the modifications are reasonable and bear some material relationship to theory of a pension system and its successful operation); Burlington Fire Fighters Ass'n. v. City of Burlington, 543 A.2d 686 (Vt. 1988) (finding that even if a party's contract rights have been impaired, the Contract Clause is only violated where the impairment is not reasonable and necessary to achieve an important public purpose).

105. P.R. CONST. art. II, § 7.

the Supreme Court of Puerto Rico in *In the Matter of Trinidad Hernandez v. Commonwealth* upheld the retirement system reform as constitutional.[106] The Puerto Rican Supreme Court relied upon the previously discussed *U.S. Trust* case, in which the United States Supreme Court held that a government can impair its contractual obligations if that impairment is reasonable and necessary to serve a more important public purpose.[107]

Relying upon this rational basis standard, the Puerto Rican Supreme Court upheld the retirement system reform as constitutional, holding that the measure was taken to prevent the retirement system collapse and Puerto Rico's credit being downgraded to junk.[108] The Puerto Rican court reasoned that such purposes were necessary and reasonable to adequately address the financial crisis that threatened the actuarial solvency of the system.[109] Additionally, the Puerto Rican court stated, "[T]he protection of contractual obligations is not absolute, as it should be harmonized with the regulatory role of the state in the public interest" and, "[f]or this reason, it is standard law that not [every compromise would constitute] an unconstitutional impairment of contract."[110] The court noted that the pension adjustments were necessary to maintain credibility in the financial markets and the solvency of the retirement system.[111]

On December 5, 2013, Governor Pat Quinn of Illinois signed into law legislation that amended the Illinois Pension Code.[112] The bill reduces the annual three percent compounded COLA for retirees, raises the retirement age by up to five years and imposes a limit on pension benefits for the highest paid employees.[113] It was widely anticipated that the Illinois legislation would face court challenges, and five lawsuits have been filed challenging the law

106. Hernandez v. Commonwealth, 188 D.P.R. 828 (2013) (translation).

107. U.S. Trust Co. v. New Jersey, 431 U.S. 1 (1977).

108. *Hernandez*, 188 D.P.R. at 836 (translation).

109. *Id.*

110. *Id.* at 834.

111. *Id.* at 839. In the recent Puerto Rican Supreme Court decision finding reform of the teachers' retirement plan unconstitutional, the court questioned the long-term effect of proposed adjustments on the pension plan and discussed whether a higher public purpose was served by leaving the teachers' pension plan intact. Asociacion de Maestros de Puerto Rico v. Sistema de Retiro Para Maestros de Puerto Rico, No. CT20142, slip op. (PR 2014).

112. Ill. Public Act 98-0599, *available at* http://www.ilga.gov/legislation/publicacts/98/PDF/098-0599.pdf.

113. *Id.*

as a violation of the Illinois Constitution.[114]

The impact of the Illinois Supreme Court's decision in Kanerva v. Weems[115] is subject to speculation. As noted, in that case, the court ruled six to one that the state constitution's prohibition against the diminishment of the benefit of any pension or retirement system applies to contributions to the cost of health care benefits. The issue is whether this decision will guide the court's consideration of the recent amendments to the Pension Code. Setting aside the question of the correctness of the court's holding,[116] the arguments in the pension reform litigation, namely that economic necessity and a higher public purpose required the modification, were simply not raised in Kanerva v. Weems on appeal. It is possible these issues may be raised on remand before the trial court. To the degree that health care benefits are to be treated the same as pension obligations, they should appropriately be adjusted just like pension costs so that they are sustainable and affordable for the reasons set forth herein.

The opponents to pension reform will also likely cite to the tentative decision in *San Jose Public Officers' Association v. City of San Jose*, which took an approach different from the Puerto Rican Supreme Court.[117] Specifically, the court found invalid provisions which, among other things, (i) provided for increased pension contributions for current employees to cover unfunded actuarially accrued liabilities, (ii) provided for an alternative retirement plan for employees who wish to avoid increased contribution rates, or (iii) permitted the city to suspend all or part of COLA payments due to all retirees in the event of a fiscal and service-level emergency.[118] However, the court rejected a number of other claims, including those based upon equitable and

114. The five lawsuits have been consolidated by the Illinois Supreme Court for hearing in the Circuit Court of Sangamon County (Springfield). Heaton v. Quinn, No. 117229 (Ill. March 3, 2014).

115 Kanerva v. Weems, 13 N.E.3d 1228 (Ill. 2014).

116 In the dissenting opinion, Justice Anne M. Burke stated that the majority's analysis —premised on its belief that the health-care benefit "flows directly from" pension membership—was "simply crafted out of whole cloth." *Id.* at 1247 (Burke, J., dissenting).

117. San Jose Pub. Officers' Ass'n v. City of San Jose, No. 1-12-CV-225926 (Superior Ct. of Ca., Santa Clara County, Dec. 20, 2013), *available at* http://www.sanjosefirefighters.com/images/shared/Measure%20B/Legal%20Documents/Santa%20Clara%20Superior%20Court%20Tentative%20Ruling%201-12-CV-225926%20June%207th%202013.pdf.

118. *Id.* at 3–7.

promissory estoppel.[119] The voters had approved all of these provisions. While referring to budget and economic crises that had precipitated the enactment of the modifications, the court focused on the violation of vested rights and did not discuss the impact the ruling would have on the ever-increasing unfunded pension liability or higher public purpose.[120] At the same time, the court did hold that the vested rights doctrine did not mean that pension provisions could never be changed.[121] The court held that pensions were capable of being modified.[122] However, according to the court, the modification of vested rights must not frustrate the reasonable expectations of the parties to the contract of employment.[123] The court did recognize that the alternative to pension reform, the reduction of salaries by four percent a year for at least four years, did not violate the law.[124] Given that this alternative would appear to be less desirable to workers, the court's conclusion is interesting.

It is also likely that the opponents of pension reform would look to the Arizona Supreme Court opinion in which the court affirmed the trial court's decision in favor of several retired judges who asserted that a state statute reducing pension benefits violated the state constitution's provision that "public retirement system benefits shall not be diminished or impaired."[125] The facts of the Arizona case are inapposite since Illinois has a special constitutional provision relating to judicial pensions.[126] Further, while the Arizona decision holds that the Contract Clause is not applicable to pension obligations in Arizona because of the separate "pension clause" in its constitution, the Arizona decision fails to address how the court's analysis can be rationalized in light of the well-established rule that the state's police power cannot be

119. *Id.* at 7.

120. *Id.* at 4.

121. *Id.* at 6.

122. *Id.*

123. San Jose Pub. Officers' Ass'n v. City of San Jose, No. 1-12-CV-225926 at 6 (Superior Ct. of Ca., Santa Clara County, December 20, 2013), *available at* http://www.sanjosefirefighter.com/images/shared/Measure%20B/Legal%20Documents/Santa%20Clara%20Superior%20Court%20Tentative%20Ruling%201-12-CV-225926%20June%207th%202013.pdf.

124. *Id.* at 3.

125. Fields v. Elected Officials' Ret. Plan, 320 P.3d 1160, 1163 (Ariz. 2014).

126. ILL. CONST. art. VI, §14 ("Judges shall receive salaries provided by law which shall not be diminished to take effect during their terms of office.").

abrogated.[127]

The Arizona Supreme Court, in dealing with changes to the statute providing for cost of living adjustments for elected officials (including judges), found that, in interpreting the Contract Clause and the Pension Clause of the Arizona Constitution, the two provisions must be read distinctively and that the full context of each provision must be given full meaning.[128] The Arizona Pension Clause provides that "membership in a public retirement system is a contractual relationship that is subject to Article II, §25 [Impairment of Contract Clause[129]] and public retirement system benefits shall not be diminished or impaired."[130] The court stated that the second part of the Pension Clause should not be read as redundant with the Contract Clause, but rather should be given meaning, with the result that it was unconstitutional to amend the cost of living adjustments as suggested by the Arizona legislation.[131] The court then decided it need not go through a Contract Clause type of analysis.[132]

2. Critique of the Arizona Supreme Court's Reasoning

The problem with the Arizona Supreme Court's interpretation is that it fails to give proper deference to the fact that a state or local government cannot surrender, eliminate, bargain away or abrogate the inalienable powers of the sovereign and the mandated governmental purpose to provide essential services to its citizens. The interpretation provided by the court would mean that Arizona, by means of a constitutional provision, would be excused from fulfilling its mandated governmental mission of providing essential public services to its citizens if it would not have sufficient funds to pay cost of living increases to elected officials. The same result would be required even though some of the elected officials were responsible for passing legislation that in reality improvidently promised more to elected officials than the state could realistically pay. Such an interpretation defies logic and the principles of

127. *Fields*, 320 P.3d at 1164. *See infra* discussion part III.*B*.2.

128. *Fields*, 320 P.3d at 1165.

129. ARIZ. CONST. art. 2, §25 ("No … law impairing the obligation of a contract, shall ever be enacted."

130. ARIZ. CONST. art. 29, §1 C.

131. *Fields*, 320 P.3d at 1164.

132. *Id.* at 1165.

prudent government. That interpretation would prevent the state or local government from providing for the health, safety, and welfare of its citizens; its fundamental mandated mission. Such an interpretation cannot be justified and clearly the exercise of a government's sovereign power to protect the general welfare of its people is paramount to any rights created by legislation for elected officials or others.[133]

The United States Supreme Court has long observed that it is beyond the authority of the state or a municipality to abrogate its sovereign power so necessary to the public to protect its citizens and to provide essential public services.[134] This principle is not limited to the Contract Clause and is a basic, founding principle of both constitutional interpretation and practical governance. There can be no after-the-fact interpretation that—in saying retirement system benefits shall not be diminished or impaired—such benefits become super-priority claims above all others and trump the mandated mission of funding essential governmental services. If the Arizona court considered the principle that any rights granted by the Pension Clause were subject to a higher public purpose, namely the mandated mission of the state and its municipalities, its decision should have been different. It should have found, as the *Asbury Park* case noted, that any impairment or diminishment was ethereal and, in reality, nonexistent because without the essential public services, there won't be the revenue to make the payments.[135]

V. A PROPOSAL FOR SOLVING THIS PROBLEM: A RECOVERY PLAN

A. Everyone Benefits from Reasonable Adjustments to Pension Benefits and Obligations to a Level That Is Sustainable and Affordable

The United States Supreme Court decisions are consistent with the view that non-impairment law is not intended to stretch pensions beyond their elastic limit. The continual raising of taxes is not the answer.[136] At the same time, workers who have labored

133. *See* Manigault v. Springs, 199 U.S. 473 (1905).

134. *See* Phillips Petroleum Co. v. Jenkins, 297 U.S. 629 (1936).

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

136. The former Mayor of Bridgeport, Connecticut, has reported that before the bankruptcy petition was filed, the Governor demanded that local taxes be raised by 18 percent,

hard deserve to be paid for past efforts, and as much as can be paid should be paid to meet previously promised obligations. Pension obligations can and must be adjusted if the payment level frustrates the fundamental purposes of government. Reductions should be based upon the municipality's realistic ability to pay pension benefits and, at the same time, assure that the ability to provide essential public services at an acceptable level is not impaired. This is to the benefit of workers as well. Workers and retirees rely on the continued success and growth of the municipality for continued employment and pension payments.

It is in the best interest of all parties working on the recovery and future success of the municipality to determine what is sustainable and affordable, acknowledging that the resulting adjustment is simply recognition of reality. Reasonable adjustment is to the benefit of workers and retirees — if the municipality continues to erode and fails with its attempted recovery, there will be less money, not more, available to fund pensions and to keep workers employed. Fair-minded persons obviously will regret that some promises made to public employees were not attainable, realistic, or founded on any prudent notion of government.

B. The Current Challenge Facing Municipalities Is Determining the Level of Pension Benefits and Obligations That Is Sustainable and Affordable

The current challenge is determining the appropriate level of pension benefits that will permit municipalities to prosper. Pensions are long-term obligations that need to be addressed for the long term. Rushing to pay unfunded pension obligations while crowding out payments for essential public services obviously can be counterproductive. To be viable, a plan of debt adjustment must include the notion that adequate public services can be provided for the long term.

1. Standard for "Feasability" under Chapter 9

While corporate bankruptcy (Chapter 11) may judge feasibility as the ability to pay pursuant to the plan over the short

which would lead to an exodus of taxpayers. Sarah Burns, *In 1991, Bankruptcy was best for Bridgeport*, CONNECTICUT POST, Sept. 14, 2012, http://www.ctpost.com/opinion/article/In-1991-bankrupt cy-was-best-for-Bridgeport-3866176.php.

term,[137] the standard for Chapter 9 should be the assurance that the municipality can provide for essential public services at an acceptable level going forward, specifically in the foreseeable future. Following this standard should provide sufficient economic stimulation to grow business opportunities and increase employment, thus fostering growth of municipal taxpayers so the municipality will survive and, hopefully, thrive. The solution should be a permanent fix, not a Band-Aid. A court-approved debt restructuring that does not embody a recovery plan that provides for essential public services at the required level for economic growth and increased tax revenues for the foreseeable long term will be doomed to failure. If a plan of debt adjustment does not address the systemic problems that led to the Chapter 9, it will fail.[138]

2. Same Standard for Addressing Financial Obligations in an Out-of-Court Restructuring

The same test should be applied in an out-of-court restructuring. The solution is not really filing for Chapter 9 and a plan of debt adjustment, but rather it is identifying a viable recovery plan. Whether outside or inside a municipal bankruptcy in Chapter 9, the legal issue of what is sustainable and affordable must be addressed and important public priorities established. The unavoidable conclusion in an out-of-court restructuring and in Chapter 9, as has been addressed by the courts in *Stockton* and in *Detroit*, is that public pensions and public pension obligations may have to be adjusted if they are not sustainable and affordable and if pension obligations prevent the municipality from obtaining a fresh start.

Municipalities, especially large ones, need to develop a viable recovery plan and, either outside a municipal bankruptcy or within it, insure that the implementation of the plan results in reinvestment in the community via essential governmental services and needed infrastructure. Pension obligations can be appropriately adjusted to what is sustainable and affordable,

137. *See* 11 U.S.C. § 1129(a)(11) (2012).

138. The issue of who represents the taxpayers, the public in a municipal bankruptcy, has been raised. The Chapter 9 debtor itself through its elected officials should be protecting the interests of its citizens by proposing only a plan that will provide long-term economic growth and essential public services, a feasible plan. If the plan does not succeed, then the voters can decide at the ballot box whether elected officials should be retained.

allowing the municipalities to invest in that which will help them recover and grow. As in *Asbury Park*, pensions are not impaired or diminished through implementation of such a plan because, realistically, all that can be paid is being paid.[139] The plan should determine affordable fixed pension payments (ideally at least comparable to Social Security level or better) that would be guaranteed by a dedicated annual payment source and additional contingent payments that would only be paid if there were increased revenues created by the success of the recovery plan. If the municipality's finances improve, there will be more funding available to pay obligations, including pensions.[140]

In no event should that contingent obligation be one that casts a dark cloud over the ability of the municipality to succeed and thrive. In determining the priority of payment from tax funds that are available, it is important to recognize (i) the higher public purpose of assuring the future of the municipality, (ii) the mandate that essential government services must be provided at an acceptable level, and (iii) the fact that the municipality above all must provide for the health, welfare, and safety of its citizens through services that are both essential to its function and mandated by its purpose.

From the standpoint of workers and retirees, a resolution can be achieved that is better than what can be obtained in the best-fought litigation or under any other mechanism by recognizing that, together with the municipality, they must (1) determine what is sustainable and affordable to allow recovery and growth for the municipality and (2) develop how the municipality can stimulate and attract business and new jobs to the community. That way workers and retirees can advocate for (and, hopefully, participate in) a share of the new tax revenues to be used in fulfilling their future pension funding needs. In following this approach, the solution to underfunding can be identified. Namely, the price for the adjustment to what is sustainable and

139. *See Asbury Park*, 316 U.S. 502.

140. The unfunded pension obligation could be split into the sustainable and affordable piece (a fixed sum payable over the years) and a contingent piece (payable if the recovery plan is successful and more revenues are available). In any event, the recovery plan should provide for periodic review and adjustment of pension obligations for the continued survival of the government and the pension fund. Obviously, any suggestion of increases in pension benefits going forward would be tied to a specific source of funding so that, at all times, the cost of pensions are sustainable and affordable.

affordable is the hardwiring of pension funding going forward. The municipality must identify and dedicate a sustainable and sufficient revenue source for the funding of pension obligations. This will ensure that it will never again repeat the unfortunate scenario of balancing budgets by forgoing pension contributions and promising future pension benefits that are not sustainable and affordable. Instead, pension obligations are funded on an agreed-upon, ongoing basis from an agreed-upon source which the municipality is obligated to fund to ensure the payment of the pensions.[141] Thus, the burden of unfunded pension obligations is not put on our children and grandchildren to the detriment of the workers, especially the youngest.[142]

What is required to achieve this realistic solution is everyone coming together as we have always done in times of crisis in the past. All concerned must work together in a selfless way to achieve the recovery of the municipality first and, hopefully, the increased revenues second, all premised upon a restructured debt that will allow this realistic resolution to happen.

VI. CONCLUSION: THE PROBLEM IS TOO BIG TO CONTINUE TO IGNORE

While the issue of modifying pension obligations is a sensitive one, failure of financially distressed municipalities to resolve now the competing interests between pension obligations and the

141. Our Founding Fathers recognized the importance of economic credibility for the nation, its states, and local governments. Alexander Hamilton, the first Secretary of the Treasury, urged the young country to pay off the Revolutionary War debt of the federal government as well as the states. Further, he noted that the secret of making public credit "immortal" is that whenever public debt is increased, it should be accompanied by a sufficient tax increase dedicated to its payment. 6 HAROLD C. SYRETT, THE PAPERS OF ALEXANDER HAMILTON (1962); 18 HAROLD C. SYRETT, THE PAPERS OF ALEXANDER HAMILTON (1973).

142. A possible solution is the use of an independent, quasi-judicial structure at the state level (*i.e.*, a Public Pension Funding Authority) that would assist a municipality in sorting out the facts as to what is sustainable and affordable and then help the troubled municipality restructure its debts. Such a structure has been proposed by the Civic Federation of Chicago in its Illinois Municipal Protection Authority. *See e.g.*, James E. Spiotto, *The Role of the State in Supervising and Assisting Municipalities, Especially in Time of Financial Distress*, 34 MUN. FIN. J. 1, 22 (2013), *available at* http://www.chapmanstrategicadvisors.com/media/publication/1_Role_of_State_Supervising_Assisting_Municipalities_in_Distress_%202011_MFJ_csa.pdf; James E. Spiotto, *Less Is More: Lessons Learned from Detroit: Bankruptcy's Unfunded Pension Battles*, MUNINET (Aug. 21, 2013), http://www.muninetguide .com/articles/less-is-more-lessons-learned-from-detroit-bankruptcys-unfund-603; Mary W. Walsh, *Stepping Up with a Plan to Save American Cities*, N.Y. TIMES DEALBOOK (Nov. 11, 2013), *available at* http://dealbook.nytimes.com/2013/11/11/stepping-up-with-a-plan-to-saveamerican-cities/?_php=true&_type=blogs&_r=0.

funding of essential costs for current public services may well render any later attempt at financial restructuring futile. The touchstone must be pension benefits that are sustainable and affordable and public services that are at a level to develop and foster growth in businesses and new jobs. Such growth will allow the municipality to increase its taxpayer base and its revenues and to meet reasonable employee-related expenses. Unless these goals are met, corporate and individual citizens will leave and the revenue available to the municipality to satisfy obligations, including pensions, will be reduced even further.

I believe that successful reform of public employees' pension benefits and obligations to a sustainable and affordable level is essential to the continued survival of a number of financially distressed municipalities. Deterioration of public services benefits no one. It is in the best interest of all parties working on the municipality's recovery to recognize what is sustainable and affordable, acknowledging that the resulting adjustment to pensions is simply recognition of reality. In the long run, this approach will be more beneficial than any litigation strategy.