

2014

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Recommended Citation

C. Scott Pryor, *Municipal Bankruptcy: When Doing Less is Best*, 88 Am. Bankr. L.J. 85 (2014).

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Municipal Bankruptcy: When Doing Less Is Doing Best

by

C. Scott Pryor*

The recent narrative of municipal bankruptcies focuses on the power of insolvent cities to reduce burdensome retiree benefit obligations.¹ From Orange County to the cities of San Bernardino and Vallejo as well as Detroit, a principal focus has been the power of cities to cut retirement benefits free of the procedural and substantive roadblocks faced by non-municipal debtors. But the story arc has changed with the filing by the City of Stockton. Stockton did not move to reject any of its labor contracts and continued to pay the California Public Employees' Retirement System all amounts due for pensions present and future. Rather than its unions, Stockton's principal bankruptcy antagonists were the holders of its municipal bond debt. Could it be that Stockton, rather than adjusting its finances at the expense of its workers and retirees, plans to do so to the detriment of its more distant creditors? Would such a plan of adjustment be fair?

Risk is inherent in all economic transactions and all creditors should understand that they are exposed to a risk of nonpayment. As the identity of creditors changes from bondholders to employees to retirees, however, actual awareness of that risk decreases. More significantly, the power to protect against that risk through use of the financial market diminishes. It is thus not surprising that state law occasionally intervenes to reallocate risk through the political process for the benefit of those less able to use the market. Whatever the reason—economic or political—the interests of some creditors are better protected from risk than others. On the one hand, the bankruptcy process takes as a given this initial allocation of risk. On the other hand, the

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¹Int'l Bhd. Of Elec. Workers v. City of Vallejo (*In re City of Vallejo*), 432 B.R. 262, 270-72 (E.D. Cal. 2010); Ass'n of Retired Emps. of City of Stockton v. City of Stockton (*In re City of Stockton*), 478 B.R. 8, 23 (Bankr. E.D. Cal. 2012); Peter Benvenuti et al., United States: An Overview of Chapter 9 of the Bankruptcy Code: Municipal Debt Adjustments, MONDAQ (Aug. 23, 2010), available at <http://www.mondaq.com/unitedstates/x//Insolvency+Bankruptcy/An+Overview+of+Chapter+9+of+the+Bankruptcy+Code+Municipal+Debt+Adjustments>.

Bankruptcy Code permits this risk to be reallocated through the adjustment process so long as that reallocation is “fair and equitable” and does not “discriminate unfairly,”—bankruptcy fairness.

As if the notion of bankruptcy fairness were not complex enough, in order to be confirmed a plan of adjustment must also be in the “best interests” of creditors. Unlike bankruptcy fairness, best interests compares a plan’s proposed reallocation of risk to the hypothetical state of affairs that would have obtained if bankruptcy had never taken place. The measure of fairness comprised in best interests is that of state law, not the Bankruptcy Code. This element will be characterized as state-law fairness in the balance of this paper. The phrase substantive fairness will compass fairness of both sorts—bankruptcy and state-law.

Whatever confirmation of a plan of adjustment requires, the power of a municipality to assume executory contracts permits reallocation of risk of nonpayment away from the contract’s counterparty free from immediate consideration of substantive fairness. Assumption of executory contracts in bankruptcy has been subject only to the business judgment rule, and substantive fairness to other parties has not played a role in judicial review. When it comes to assumption, bankruptcy courts have generally paid substantial deference to the discretion of the management of the debtor. Some courts have imposed a heightened standard on debtors seeking to *reject* contracts deemed to have substantial public implications. No court, however, has imposed anything other than the business judgment standard on decisions to *assume*. Can assumption preempt substantive fairness?

The brevity of chapter 9 means that Congress hasn’t provided a straightforward answer to these questions. The tension between congressional power under Article I of the Constitution and the rights reserved to the states by the Tenth Amendment subjects construction of chapter 9 to an overlay of constitutional interpretation. The rarity of chapter 9 bankruptcies entails that much judicial gap-filling remains to be done. This uncertain state of affairs generates a powerful incentive among most parties to settle. Incentives exist to resolve competing claims because a nonconsensual plan must be fair in both the bankruptcy and state-law senses *and* because the contents of substantive fairness are underdetermined. Chapter 9 thus functions to create an institutional game of Chicken driving stakeholders to consensus.

This article will proceed in four parts. Part I will briefly consider the circumstances leading to Stockton’s bankruptcy, summarize relevant California law, and review the opinions thus far reported in its case. Part II will consider public finance in contemporary America and its attendant risks as well as their contractual and state-law allocation among various interested parties. In Part III the question of whether a municipality can “unbundle” assumption of certain contracts from plan confirmation will be addressed. Fi-

nally, Part IV will examine several bankruptcy confirmation issues: What protections do the twin requirements of “fair and equitable” and no “unfair discrimination”—two aspects of bankruptcy fairness—and the mandate of “best interests of creditors”—state law fairness—provide for creditors? And what does it mean that a municipal plan of adjustment must not propose actions prohibited by law? Finally, what should the bankruptcy court do when these requirements collide?

I will examine these issues principally through the lens of the Stockton bankruptcy. Although California law is integral to this analysis, the applications of my conclusions are not limited to California municipal bankruptcies. Separation of contract assumption from plan confirmation should be relevant to all municipal cases and the effects on public finance of disparate treatment of pensions and other claims clearly have ramifications beyond the borders of California. In any event, the many lacunae of chapter 9 and the paucity of reported decisions on these issues creates an opening for new applications of existing law and I hope this piece will spur creative and thoughtful consideration of such uses.

I. THE (IM)MOVABLE OBJECT AND THE (IR)RESISTIBLE FORCE

A. SETTING THE SCENE

The City of Stockton filed its chapter 9 petition on June 28, 2012. Stockton’s eligibility for relief was vigorously contested by two bond insurers, collectively known as the “capital markets creditors,” who had insured Stockton’s general obligation bonds.² Unlike other chapters of the Bankruptcy Code, entry of an order for relief under chapter 9 is not automatic.³ An entity must demonstrate the presence of five factors to be eligible for chapter 9⁴ and the capital markets creditors denied that Stockton met two of them: good faith and insolvency.⁵ In addition to the city itself, the California Public Employees’ Retirement System (CalPERS) strongly supported Stock-

²A third entity, Ambac Assurance Corporation, insured Stockton’s participation certificates issued on behalf of the city’s public financing authority. Unlike the two capital markets creditors, however, Ambac settled with Stockton without litigation. See Order Granting City of Stockton’s Motion for Order Approving Compromise Pursuant to Federal Rule of Bankruptcy Procedure 9019, *In re City of Stockton*, No. 12-32118 (Apr. 2, 2013), ECF No. 888. Two other bondholders, Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund, that had not taken an active role in the Stockton bankruptcy, later took up the positions previously asserted by the capital markets creditors.

³11 U.S.C. § 921(d).

⁴A municipality may be a debtor under chapter 9 only if (1) it is a municipality, (2) it is insolvent, (3) it desires to make an adjustment of its debts, (4) it has negotiated in good faith with its creditors (or can show that such negotiations would have been impracticable), and (5) it is specifically authorized by state law to file for relief under chapter 9. 11 U.S.C. § 109(c).

⁵See *In re City of Stockton*, 493 B.R. 772, 783–791 (Bankr. E.D. Cal. 2013) (*Stockton V*) (addressing Stockton’s eligibility to be a debtor under chapter 9).

ton's eligibility for relief under chapter 9. This support was not a surprise. Prior to filing Stockton had made clear that it did not intend to terminate its agreement with CalPERS and that it would not impair the claims of its retirees whose pensions CalPERS administered. The bankruptcy court ultimately ordered relief on April 1, 2013 after a three-day trial. The court's opinion—*Stockton V*—is considered below.

Long before Stockton sought bankruptcy relief, it had agreed to provide pensions and health-care benefits to its retirees, and had contracted with CalPERS to administer those benefits.⁶ The financial burden of those benefits on the city increased over the decades through what the bankruptcy court characterized as an “encrustation of a creeping multi-decade, opaque pattern of above-market compensation of employees.”⁷ From the outset, each labor agreement contained some retirement benefits but over time those benefits increased and thus Stockton's future obligations to its retirees also increased. By the time it filed, the city provided generous lifetime healthcare benefits regardless of the length of an employee's service.⁸ Its pension plans permitted “add-pays” and “pension-spiking” that allowed employees to manipulate their income for their final year of employment and thus increase the pensions they would receive.⁹

Of course, Stockton also had current obligations to its employees who provided services such as police and fire protection. Like its obligations to its retirees, the cost of Stockton's labor agreements with its employees had increased substantially until 2010, when it belatedly began to curtail its labor costs. In the years immediately before filing, Stockton cut the number of its employees from 1,886 in 2008 to 1,420 at the end of 2011.¹⁰ To complicate

⁶John Heilman, Edmund Edelman, & Thomas J. Clark, *Health Care Issues for City and State Employees*, 16 WHITTIER L. REV. 51, 56 (1995):

The California Public Employees Retirement System, or CALPERS, was originally established in 1935 to administer the retirement program for state employees. Over the years, the system has come to include employees of 900 other public agencies such as cities, counties, and school districts. The system manages roughly \$80 billion, depending on the state of the stock market. By doing so, CALPERS is the largest retirement system in the country.

See also KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION 2* (5th ed. 2010) (observing that employee benefits were initially utilized primarily during World War II).

⁷*Stockton V*, 493 B.R. at 779.

⁸See *id.*

⁹*Id.* See John Gioia, *Readers' Forum: Misguided Attempt to Top Pension Spiking*, CONTRA COSTA TIMES (Aug. 14, 2010), available at http://www.contracostatimes.com/opinion/ci_15770581; MaryJo Webster et al., *Public Pension Spiking: Public Overtime Hours Soar for St. Paul Fire Supervisors*, PIONEER PRESS (Dec. 8, 2012), available at http://www.twincities.com/ci_22148782/public-pension-spiking-overtime-hours-soar-st-paul?IADID=search-www.twincities.com-www.twincities.com (discussing techniques of manipulation utilized to increase benefits under defined-benefit pension plans).

¹⁰See *Stockton V*, 493 B.R. at 780.

fiscal matters, the economic recession beginning in 2008 led to a 50% decline in property values as well as a substantial reduction in sales tax revenues.¹¹ Yet, there were no reductions in Stockton's obligations to provide services to its residents.

The continuing subtext relating to Stockton's eligibility was the city's stated intention not to reject its collective bargaining agreements and to pay CalPERS. While the city and its unions had negotiated toward reduction of current levels of staffing and liberalization of work rules,¹² the city professed that it did not intend to effect any changes in the pension benefits paid to retirees.¹³ Stockton's "Ask," its 790-page prepetition proposal to creditors, combined a promise of no impairment of pensions with a proposal for substantial delays in its payments to bondholders. Driving home its preferences, even before filing Stockton defaulted on its bond payments to relieve its cash flow crisis.¹⁴ The city's prepetition default in payment to the capital markets creditors and its decision to continue to pay CalPERS created a conflict between two financially powerful sets of parties battling to retain (or get) a greater share of Stockton's future revenues. And, given that many other cities in the United States are experiencing fiscal pressures like Stockton's, what happens in Stockton's bankruptcy case could have nationwide reverberations.¹⁵

CalPERS charges each participating municipality an annual sum which, together with anticipated investment returns, it projects to be sufficient to pay retirees when their pensions are due.¹⁶ A municipality determines the level of benefits it will pay, generally through a collective bargaining agreement, and CalPERS determines the rate of contribution (and can change the rate when its actuary deems it necessary). CalPERS thus has two roles in Stockton's bankruptcy case. First, it stands in the shoes of Stockton's retired employees whose benefits it pays. While the United States Trustee has ap-

¹¹*Id.* at 780.

¹²*Id.* at 785.

¹³*Id.* at 779-80. Stockton also took the position that it could not negotiate with its retirees before filing because they had no common representative with whom to negotiate. *See id.* at 794.

¹⁴*Id.* at 781.

¹⁵The chapter 9 filing by the City of Detroit characterized by the city's proposal to pay substantially less than due bondholders and retirees is the most current example. *See* Mary Williams Walsh & Steven Yaccino, *In Embattled Detroit, No Talk of Sharing Pain*, N.Y. TIMES, June 17, 2013, available at <http://www.nytimes.com/2013/06/18/business/in-embattled-detroit-no-talk-of-sharing-pain.html?pagewanted=all>. *See also* City of Detroit Proposal for Creditors 106-09, available at <http://www.freep.com/assets/freep/pdf/C4206913614.PDF> (describing proposed replacement of current unsecured debt with "Limited Recourse Participation Notes" bearing interest at rate of 1.5% per year with non-guaranteed principal payments).

¹⁶*See* CAL. GOV. CODE § 20532.

pointed an official committee of retirees in Stockton's case,¹⁷ the interests of the retirees and CalPERS with respect to pension benefits coincided. Second, in its capacity as plan administrator, CalPERS has the power to set the amount of the annual contributions to be paid by municipalities that have contracted for its services.¹⁸ In the early years of the twenty-first century, CalPERS underestimated the ultimate costs of the benefits it administered.¹⁹ Thus, since 2008, CalPERS has increased the assessments it makes on municipalities.²⁰ Even so, some argue that municipalities should be making greater contributions if CalPERS is ultimately going to be able to pay all promised benefits.²¹

Like most cities in the United States, Stockton's principal source of revenue is real estate taxes. Stockton's sales and use tax revenues increased by sixty-five percent between 2000 and 2006.²² Thereafter, according to the Metropolitan Statistical Areas ranking, house prices in Stockton dropped 57.22% in the five-year period from 2008 to 2012,²³ and the city's revenues decreased thirty percent from fiscal year 2005-2006 to fiscal year 2009-2010. Stockton's city government did not believe it could close its revenue shortfall by raising taxes because of California's well-known Proposition 13, which froze assessments for real property at their 1976 levels, set the tax rate at 1% of that valuation, and limited annual increases to 2%.²⁴ Combined with Proposition 218, which requires that a majority of voters approve new or increased general taxes,²⁵ the ability of Stockton to generate new revenue was severely limited.

Like other cities in the United States, Stockton borrowed money for various purposes. Indeed, borrowing rather than taxing is a long-recognized prob-

¹⁷Notice of Appointment of Official Committee of Retirees at 1-2, *In re City of Stockton*, No. 12-32118 (Apr. 1, 2013), ECF No. 846.

¹⁸In addition, under California law CalPERS has the power to calculate the termination liability of a municipality that withdraws from CalPERS's administration of its retirement benefits. See CAL. GOV. CODE § 20574. The same provision also provides that CalPERS will have a lien on the assets of the terminating municipality for the "actuarially determined deficit in funding for earned benefits" for its employees.

¹⁹See Adam B. Summers, *How California's Public Pension System Broke (and How to Fix It)*, REASON FOUNDATION (June 2010), available at http://reason.org/files/california_pension_crisis_reform_study.pdf.

²⁰Victoria Colliver, *CalPERS OKs Jump in Health Co-Pays*, SAN FRANCISCO CHRONICLE, May 17, 2007, at C1, available at www.sfgate.com/business/article/CalPERS-OKs-jump-in-health-co-pays-2560039.php.

²¹See also *infra* text accompanying notes 102-109 (discussing underfunding in general).

²²Declaration of Laurie Montes in Support of City of Stockton's Statement of Qualifications under Section 109(c) of the Bankruptcy Code at ¶ 8, *In re City of Stockton*, No. 12-32118 (June 29, 2012), ECF No. 23.

²³*Id.* at Exhibit F, unnumbered page 32.

²⁴CAL. CONST. art. XIII A, §§ 1(a) and 2(b).

²⁵CAL. CONST. art. XIII C, § 2.

lem of political agency.²⁶ By the time of its filing, Stockton owed over \$250 million to bondholders.²⁷ Of this total, a substantial portion was due on revenue bonds while the balance was for general obligation bonds. This distinction is particularly important in cases of municipal insolvency because revenue from the sources of payment dedicated to revenue bonds repayment cannot be used for any other purpose.²⁸ A receiver was appointed to collect the revenues from the parking garages and other assets pledged as collateral for its revenue bonds even before Stockton filed bankruptcy.²⁹

From 2000–2007 the creditworthiness of most municipal borrowing was enhanced by letters of credit, intra-governmental guaranties, or insurance.³⁰ The availability of insurance, however, has declined markedly since 2008.³¹ Two bond insurers are active in Stockton's bankruptcy—National Public Finance Guarantee Corporation and Assured Guaranty Corporation.³² Indeed, apart from the trustees for holders of its revenue bonds, virtually all of Stockton's bondholders have been paid by the insurers. Thus, it is the insurers who stand to lose relative to retirees if Stockton impairs their claims but does not impair the pension claims of its retirees.

B. CALIFORNIA CODE AND CASES

When a municipality contracts with CalPERS to administer its retirement obligation, CalPERS has the statutory authority to calculate the necessary contributions.³³ California courts have repeatedly held that the retirement obligations due to public employees are immune from modification under California statutes and the state constitution.³⁴ The California Con-

²⁶See David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 Hous. L. Rev. 1063, 1072 (2013).

²⁷See List of Creditors Holding 20 Largest Unsecured Claims, *In re City of Stockton*, No. 12-32118 (June 28, 2012), ECF No. 4.

²⁸See *infra* text accompanying notes 135–139.

²⁹See *Stockton V*, 493 B.R. at 782.

³⁰See U.S. SEC. AND EXCH. COMM'N, STAFF REPORT ON THE MUNICIPAL SECURITIES MARKET ii (2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf> (the "SEC REPORT").

³¹*Id.* at 49. Even though issuance of bond insurance and stand-by letters of credit have decreased, a "significant portion" of issuances of new municipal debt is enhanced by some form of governmental guaranty. *Id.* at 50. In other words, a higher governmental body guarantees payment of a security issued by a lower governmental body, agency, or instrumentality, or of a private entity that benefits from conduit financing. See also *infra* text accompanying note 85.

³²The place Assured Guaranty, Ltd. and its affiliates occupied in the municipal bond insurance market through 2009 is worth noting: "Through its two insurer subsidiaries, [Assured] commanded 100% of the [bond insurance] sector . . . in the first quarter [of 2010] . . .". Patrick McGee, "Assured All Alone on Top," *The Bond Buyer* (Apr. 16, 2010), available at http://www.bondbuyer.com/issues/119_321/assured_quarterly_rankings-1010938-1.html.

³³See *supra* text accompanying notes 18–20.

³⁴See, e.g., *Betts v. Bd. of Admin.*, 582 P.2d 614, 617 (Cal. 1978) ("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

stitution mandates that CalPERS “administer the system in a manner that will assure prompt delivery of benefits and related services to the participants,”³⁵ which the California Supreme Court takes to prohibit any downward modification to public employee pensions. California cases have also made clear the inviolability of benefits promised to public employees by holding that pension obligations existing on the date of an employee’s hiring cannot be substantively altered.³⁶ Rights to benefits vest immediately upon employment.³⁷ Any non-consensual changes may thus be accomplished—if at all—only in bankruptcy.³⁸ This strong set of entitlements under California law constitutes the substance of state-law fairness protected by the best interests test of chapter 9.

C. ROUNDS 1-5

As of this writing the bankruptcy court has issued five reported decisions in Stockton’s bankruptcy. None have resolved whether a plan that leaves retiree pension obligations unimpaired but impairs the rights of bondholders can pass the test of bankruptcy fairness, or whether the city may assume its pension-related agreements over the objection of its creditors. Indeed, the Bankruptcy Court has left open the issue of whether a plan leaving retiree pensions unimpaired can be crammed down over the objection of impaired creditors.³⁹ The issue of bankruptcy fairness—the extent to which the principle of *pari passu* must be applied—remains in play.

Collectively, however, these five opinions suggest a developing point of view by the bankruptcy court with regard to bankruptcy fairness. *Stockton I*⁴⁰ addressed the city’s motion to dispense with the confidentiality provisions of California law relating to much of what had transpired during the statutorily required pre-filing neutral evaluation process.⁴¹ The limited disclosure authorized by the court pertained to the factor of Stockton’s good faith for eligibility for relief under chapter 9. What was disclosed, however, had a negative effect on the court’s perception of the good faith of the capital mar-

contractual obligation.”). See generally Amy B. Monahan, *Statutes as Contracts? The “California Rule” and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029 (2012).

³⁵CAL. CONST. ART. XVI, § 17(a).

³⁶See *Kern v. City of Long Beach*, 179 P.2d 799, 802 (Cal. 1947) (“Since a pension right is ‘an integral portion of contemplated compensation,’ it cannot be destroyed, once it has vested, without impairing a contractual obligation” (citation omitted)).

³⁷*Betts*, 582 P.2d at 617.

³⁸CalPERS takes the position that benefits cannot be altered even in bankruptcy. See Statement of Peter Mixon for CalPERS Board of Administration (September 12, 2012), available at <http://www.calpers.ca.gov/eip-docs/about/pubs/calpers-legal-position-municipal-bankruptcies.pdf>.

³⁹*Stockton V*, 493 B.R. at 786.

⁴⁰*In re City of Stockton*, 75 B.R. 720 (Bankr. E.D. Cal. 2012).

⁴¹*Id.*

kets creditors.⁴² The court's conclusion that they had not negotiated in good faith as required by California law could undercut any objection the capital markets creditors might later make to unfair discrimination under a plan.

*Stockton II*⁴³ raised several of the issues at the core of CalPERS/capital markets creditors conundrum. Days after the filing, Stockton implemented a budget that reduced retiree health benefits.⁴⁴ The affected retirees promptly objected. The court made short shrift of the retirees' constitutional attack, i.e., that the Contracts Clause prohibits unilateral contractual changes. While the court noted that the Constitution bars states from "impairing the Obligation of Contracts,"⁴⁵ it went on to observe that Congress has the power to do so under the Bankruptcy Clause.⁴⁶ The Supremacy Clause confirms this result even when a city, as an instrumentality of a state, is also subject to a state constitutional prohibition prohibiting impairment of contracts.⁴⁷ The Constitution makes the risk of insolvency part of the evaluation of substantive fairness.

The opinion in *Stockton II* spent more time on the retirees' statutory objection to reduction of their health benefits and affirmed a municipality's near plenary power to *reject* executory contracts. Subject only to the Supremacy Clause, sections 903 and 904 of the Bankruptcy Code protect a state's Tenth Amendment sovereignty by, on the one hand, reserving to the states power over their municipalities and, on the other, limiting the power of the courts to interfere with a municipal debtor's expenditures.⁴⁸ Section 903 specifically excludes the state's control of the "political or governmental powers" of the municipality from the bankruptcy court.⁴⁹ Section 904 effectively functions "as an anti-injunction statute" so the court in *Stockton II* concluded that it lacked the judicial power to compel the city to continue to pay its retiree health benefits regardless of the merits of the retirees' claims under state law.⁵⁰ At this stage, bankruptcy fairness trumped state-law fairness.

⁴²See *infra* text accompanying notes 69-73 with respect to *Stockton V*.

⁴³*Ass'n of Retired Emps. of Stockton v. City of Stockton (In re City of Stockton)*, 478 B.R. 8 (Bankr. E.D. Cal 2012).

⁴⁴*Id.* at 14.

⁴⁵U.S. CONST., art. I, § 10, cl.1. See *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234 (1978) (invalidating legislation that retroactively altered private pension obligations); *Unites States Trust Co. v. New Jersey*, 431 U.S. 1 (1977) (striking down legislation allowing state to alter terms of bond obligations retroactively). But see Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 *FORD. URB. L.J.* 639, 640-53 (2012) (describing variety of subconstitutional but effective ways of municipalities to evade obligations to creditors).

⁴⁶478 B.R. at 15.

⁴⁷*Id.* at 16. See *supra* text accompanying note 35.

⁴⁸*Id.* at 16-17.

⁴⁹11 U.S.C. § 903 ("This chapter does not limit or impair the power of a State to control . . . a municipality . . . in the exercise of the political or governmental powers of such municipality . . .").

⁵⁰478 B.R. at 22 ("Under any definition of a § 365 executory contract, the plaintiffs' prior full perform-

The balance of the opinion in *Stockton II* is significant for the conflict between CalPERS and the capital markets creditors. First was the court's commonplace observation that the "§ 365 executory contract provisions apply in chapter 9 cases by virtue of § 901(a)."⁵¹ More significant was the court's conclusion that the city's obligations to its retirees are not executory contracts: "Performance does not remain due to some extent *on both sides*—there are no reciprocal obligations with performance due by both parties."⁵² In other words, because the retirees no longer owe any duties to the city, their interests in Stockton's bankruptcy are only as claimants, not executory contract counterparties.⁵³ Finally, *Stockton II* followed the majority of courts and held that sections 1113 and 1114 of the Bankruptcy Code do not apply in a chapter 9 case. Section 901(a) does not incorporate the provisions of chapter 11 that afford additional protection to collective bargaining agreements and retirement obligations.⁵⁴ Only the marginally heightened standard of review of rejection of a collective bargaining agreement provided by the Supreme Court in *Bildisco*⁵⁵ applies to a municipality.⁵⁶ Congress has left a greater risk of insolvency on municipal employees than on non-public union workers.

The decision in *Stockton III*⁵⁷ dealt with an extension of the automatic stay to municipal officers during the pendency of a chapter 9 case. *Stockton IV*⁵⁸ demonstrates further extension of judicial deference to municipal decision-making. While its bankruptcy was pending, Stockton agreed to settle a prepetition claim that its police officers had used excessive force in connec-

ance means they have no executory contract. . . . To the contrary, and it is hereby so held, § 904(2) prevents this court from granting the relief requested in this proceeding.”)

⁵¹*Id.* at 21.

⁵²*Id.* at 22 (emphasis added).

⁵³The court's implicit adoption of the Countryman test of executoriness will receive further discussion in Part III.

⁵⁴ See *Orange Cnty. Emps. Assn. v. Cnty of Orange* (*In re Cnty. of Orange*), 179 B.R. 177, 182-83 (Bankr. C.D. Cal. 1995); *In re City of Vallejo*, 432 B.R. 262, 270-71 (E.D. Cal. 2010); David S. Kupetz, *Municipal Debt Adjustment Under the Bankruptcy Code*, 27 URB. LAW. 531, 534 n.11 (1995).

⁵⁵*NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 526 (1984):

[T]he Bankruptcy Court should permit rejection of a collective-bargaining agreement under § 365(a) of the Bankruptcy Code if the debtor can show that the collective-bargaining agreement burdens the estate, and that after careful scrutiny, the equities balance in favor of rejecting the labor contract. The standard which we think Congress intended is a higher one than that of the “business judgment” rule, but a lesser one than that embodied in the REA Express opinion of the Court of Appeals for the Second Circuit.

⁵⁶478 B.R. at 23 (“The judicial consensus is that *Bildisco* controls rejection of collective bargaining agreements in chapter 9 cases.”).

⁵⁷*In re City of Stockton*, 484 B.R. 372 (Bankr. E.D. Cal. 2012).

⁵⁸*In re City of Stockton*, 486 B.R. 194 (Bankr. E.D. Cal. 2013).

tion with a drug-related detention.⁵⁹ The city then moved for a declaration that it need *not* seek bankruptcy court approval of the settlement.⁶⁰ The capital markets creditors objected to the contention that a municipality had the unilateral power to settle disputed matters without complying with the procedure provided in rule 9019 of the Federal Rules of Bankruptcy Procedure.⁶¹ Rule 9019, the creditors argued, provides the exclusive procedure by which a debtor can compromise a claim. Rejecting their argument, *Stockton IV* sustained the city's position that the Bankruptcy Code does not require a municipality to comply with rule 9019: "[T]he bankruptcy court cannot prevent a chapter 9 debtor from spending its money for any reason, even foolishly or in a manner that disadvantages other creditors, unless the municipality consents to such judicial oversight."⁶² Municipal freedom to settle claims apart from judicial oversight deserves some explanation.

As a general rule, section 363 of the Bankruptcy Code⁶³ is the justification for the requirement that debtors seek judicial approval of settlements.⁶⁴ Consistent with the limitation of the bankruptcy court's powers under section 904 of the Bankruptcy Code, section 901(a) omits section 363 from its list of provisions operative in chapter 9. Thus, rule 9019 notice procedures apply to a municipal debtor only to the extent it chooses to seek court approval of a settlement of a dispute.⁶⁵ Apart from the city's choice to seek judicial approval, neither a creditor nor any other stakeholder in a municipal bankruptcy has standing to object to the settlement. The Tenth Amendment concerns that animated congressional concern to keep the bankruptcy courts out of the sphere of municipal government effectively allocates the risk of decisions about current expenditures from a city to its stakeholders.

Stockton IV did not leave the capital markets creditors without any suc-

⁵⁹Motion for Relief from Automatic Stay at 2, *In re City of Stockton*, No. 12-32118 (Oct. 23, 2012), ECF No. 586.

⁶⁰City of Stockton's Motion for Order (1) Ruling That Approval of Settlement Agreement is not Required Under Rule 9019 of the Federal Rules of Bankruptcy Procedure; or Alternatively (2) Approving Settlement Agreement Pursuant to Rule 9019 at 2, *In re City of Stockton*, No. 12-32118 (Oct. 23, 2012), ECF No. 585.

⁶¹484 B.R. at 195.

⁶²*Id.* at 198. The court grounded its decision on a review of the history of the Bankruptcy Act, the Supreme Court's 1930s decisions in connection with Congress's first ventures into municipal bankruptcy, and the plain meaning of section 904 of the Bankruptcy Code. In sum, as the court went on to observe, "§ 904 means that the City can expend its property and revenues during the chapter 9 case as it wishes. It can pay any debt in full without permission from the court." *Id.* at 199.

⁶³11 U.S.C. § 363(b)(1) ("The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . .").

⁶⁴Michael P. Richman and Brian Smith, *Should Rule 9019 Settlements be Treated as Property of the Estate Subject to the Requirements of Section 363 of the Bankruptcy Code?*, 21 NORTON J. BANKR. L. & PRAC. 1 Art. 2 (2012).

⁶⁵484 B.R. at 197 ("Rule 9019 applies in chapter 9 cases only if the debtor elects to 'consent' per § 904 to have the court consider approval of a compromise.").

cor. Even though "the court cannot prevent or disapprove a settlement or compromise,"⁶⁶ a municipality's overreaching during the pendency of its chapter 9 case may make ultimate confirmation of its plan more difficult. The court's cautionary language is worth noting: "The capital market creditors argue that unconstrained settlements amount to a creeping plan of arrangement. Perhaps so. Perhaps such a creep is legitimate and sensible. Perhaps nefarious. But, in any event, the day of reckoning comes at the plan confirmation hearing."⁶⁷ We will return to issue of "creeping confirmation" in Part III,⁶⁸ but here it is sufficient to note that bankruptcy fairness remains in play. Risk shifting during the pendency of a chapter 9 case remains subject to the confirmation requirement of substantive fairness.

Finally, nearly nine months after Stockton filed its petition for relief, *Stockton V*⁶⁹ saw the court address the fundamental question of whether Stockton was eligible to be a debtor under chapter 9. Despite vigorous opposition by the capital markets creditors, the court upheld Stockton's right to be in chapter 9 and entered an order for relief. While acknowledging the validity of criticisms of Stockton's prebankruptcy city government,⁷⁰ the court went on to chastise the capital markets objectors in blunt terms,⁷¹ specifically finding *they* had not negotiated in good faith as required by California law.⁷² Yet as seen in *Stockton IV*, the court hedged its pro-city conclusion by observing that the question of the city's relationship to CalPERS remains an issue for confirmation.⁷³ The court did not, however, address the broader issue of Stockton's pension obligations to its retirees. The ultimate relationship between state-law fairness and bankruptcy fairness was left unresolved.

When the one-year anniversary of the Stockton chapter 9 passed, the CalPERS/capital markets creditors conundrum remained unresolved. None-

⁶⁶484 B.R. at 199.

⁶⁷*Id.*

⁶⁸See *infra* text accompanying notes 153-184.

⁶⁹*Stockton V*, 439 B.R. 772.

⁷⁰*Id.* at 779 ("City accounts were in such disarray that it has taken literally years to unscramble them. Various work rules were contractually agreed upon, often without approval in public view by the City Council, that left little latitude for exercise of managerial supervision. And one wonders about what prior City Councils had been doing.")

⁷¹See, e.g., *id.* at 787 ("[T]he decision makers for the capital markets creditors need to check their testosterone at the door [and] stop assuming that they are spending their opponent's money when they direct their counsel to pursue wasteful legal tasks . . .").

⁷²See *id.* at 786 ("[T]his court is persuaded by a preponderance of evidence that neither National Public Finance nor Assured Guaranty negotiated in good faith during the California neutral evaluation process.")

⁷³*Id.* at 786 ("Although the CalPERS issue will become an important question if the objectors raise it in a challenge to confirmation . . ."). Indeed, the court had some choice words for CalPERS: "And CalPERS itself has been bellowing and pawing the sidelines during the eligibility phase waiting for the main event that will come only after relief is ordered." *Id.* at 797.

theless, the set of published opinions suggested a weakened position for the capital markets creditors. Stockton prevailed on each contested matter and, while the court was careful to leave confirmation matters unresolved, the breadth of discretion afforded to the city reduced the likelihood that the capital markets creditors would be able to block a plan that treated them unfavorably when compared to retirees. Substantive fairness runs the risk of being cabined by facts on the ground as well as the momentum of the case.

II. MUNICIPAL FINANCE

A. RISK DESCRIBED

In 2012 the United States Securities and Exchange Commission (SEC) issued a substantial report addressing several areas of concern with the municipal securities market.⁷⁴ The SEC Report made a number of background statements about the parlous state of municipal finance in America. First was its observation about the amount of municipal debt: the nominal amount of municipal securities outstanding at the end of the first quarter of 2013 was \$3.73 trillion,⁷⁵ an amount that has increased (albeit at a slower rate) even since the onset of the financial crisis in 2008.⁷⁶ Second were its observations about the nature of “credit enhancement.” The SEC Report found that prior to 2007 “more than half of all new issues of municipal securities were credit-enhanced.”⁷⁷ Since 2008, however, private credit enhancement in the form of bank-issued letters of credit and traditional bond insurance has fallen substantially.⁷⁸ Instead of private insurance, credit enhancement currently takes the form of guaranties by *other* governmental entities of the debt of a lower-level or affiliated issuer.⁷⁹ It remains to be seen whether higher-level political decision makers will better address the misdirected incentives of their municipal counterparts.⁸⁰

The next concern was with the opaque nature of the secondary market in

⁷⁴SEC REPORT, *supra* note 30. The SEC REPORT explains that municipal securities are issued by state and local governmental entities “to finance a variety of public projects, to meet cash flow and other governmental needs, and to finance non-governmental private projects . . .” *Id.* at 5.

⁷⁵See *Outstanding U.S. Bond Market Debt*, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (“SIFMA”), available at <http://sifma.org/research/statistics.aspx> (accessed June 19, 2013).

⁷⁶SEC REPORT, *supra* note 30, at 6.

⁷⁷*Id.* at 49.

⁷⁸*Id.* For a history of municipal bond insurance from its beginnings in 1971 and its growth through the early 2000s see Jonathan B. Justice & Steward Simon, *Municipal Bond Insurance: Trends and Prospects*, 22 PUB. BUDGETING & FIN. 114 (2002). For an account of the crisis in bond insurance in 2007-2008, see FINAL REPORT OF NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 276-77 (2011).

⁷⁹See *supra* text accompanying note 31. Of course, unless carefully calibrated, guaranties by other units of government may induce unwise risk taking by municipalities. See Clayton Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 286 (2012).

⁸⁰See *infra* text accompanying notes 96-97.

municipal securities.⁸¹ According to the SEC Report, “information about the prices at which market participants may be willing to buy or sell a municipal security, and who might be interested, is not broadly available. . . .”⁸² Thus, while the secondary market in municipal securities is active, matching small transactions is not straightforward and current pricing information is often lacking. The prevalence of many relatively small retail investors attracted by tax subsidies for municipal securities exacerbates this problem.⁸³

Finally, with respect to default, the SEC Report observed that municipalities have invoked legal insolvency regimes—state receiverships and chapter 9—only infrequently.⁸⁴ The near-perfect record of payment of municipal securities has provided the historical cocoon that encouraged investors to be lackadaisical about the fiscal and financial fundamentals of municipal debt issuers. And it is the issuers’ historic fear of default—and its ramifications—that Stockton threatened to overturn. Instead of the issuers, it could have been the turn of bondholders to be saddled with more of the risk of default.

Payment of municipal securities comes from a variety of sources including the general revenues of the municipality (the so-called “full faith and credit” of the issuer based upon its full taxing powers), receipts from only specified taxes, revenue generated from public projects, and payments from private entities (who benefit from lower rates of interest on municipal securities through so-called conduit revenue financing).⁸⁵ More obscure forms of municipal securities include moral obligation bonds and double-barreled bonds.⁸⁶ Payment of municipal securities may be unsecured or secured by municipal

⁸¹See SEC REPORT, *supra* note 30, at 105 (“[M]arket participants have stated that access to current financial information about issuers or obligated persons may be limited, difficult to find, or unavailable.”).

⁸²*Id.* at 115.

⁸³See Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1440 (2012) (“The presence of so many retail investors raises questions of market efficiency, as retail investors often lack the access to information and the analytical capacity of institutional investors.”).

⁸⁴SEC REPORT, *supra* note 30, at 24 (“Since 1980 there have been, on average, only about 7.5 municipal bankruptcy filings per year . . .”).

⁸⁵*Id.* at 1.

⁸⁶See *Certain Types of Municipal Securities*, MUN. SEC. RULEMAKING BD., available at <http://www.msrb.org/Municipal-Bond-Market/About-Municipal-Securities/Types-of-Municipal-Securities.aspx> (accessed June 25, 2013). A moral obligation bond is:

usually issued by a state or agency, that is secured by a non-binding covenant that any amount necessary to make up any deficiency in pledged revenues available for debt service will be included in the budget recommendation made to the state legislature or other legislative body, which may appropriate moneys to make up the shortfall. The legislature or other legislative body, however, is not legally obligated to make such an appropriation.

Id. A double-barreled bond is one that is “secured by a defined revenue source as well as the full faith and credit of an issuer that has taxing power.” *Id.*

assets or the income from such assets.⁸⁷ Revenue bond issues collateralized by assets or payment streams are far more secure than general obligation bonds.⁸⁸ While the power to levy taxes appears to be a solid foundation on which to base payment of general obligation bonds, forcing a recalcitrant municipality to use that power may be challenging.⁸⁹

Given its limited jurisdiction, the SEC's enforcement measures with respect to municipal securities have been limited to occasional civil actions for fraud.⁹⁰ The antifraud provisions prohibit any person, including municipal issuers, from making an untrue statement of material fact or omitting any necessary material facts in relation to the offer, purchase, or sale of any security.⁹¹ Thus, the SEC brought an action against San Diego in 2006 for making false and misleading statements in disclosure statements⁹² and then in 2010 against New Jersey for similar reasons.⁹³ The SEC did not seek criminal prosecution or sanctions beyond injunctive-style relief in these cases, or any other municipal cases.⁹⁴

B. RISK HIDDEN

Public-sector retirement obligations have increased at a greater rate than

⁸⁷See *infra* text accompanying note 138 (discussing unavailability of liens securing special revenue bonds).

⁸⁸See *infra* text accompanying notes 134-36 (discussing exemption from automatic stay of § 362(a) of the Bankruptcy Code).

⁸⁹See Clayton P. Gillette, *Bankruptcy and Its By-Products: A Comment on Skeel*, 50 HOUS. L. REV. 1129, 1132 (2013) (observing that states may employ defense of sovereign immunity); U.S. CONST. amend. XI (barring creditors from suing states in federal court for damages under state contract law). See also Emily D. Johnson & Ernest A. Young, *The Constitutional Law of State Debt*, 7 DUKE J. CONST. L. & PUB. POL'Y 117, 125 (2012).

⁹⁰With exception of antifraud provisions, both the Securities Act of 1933, 15 U.S.C.A. § 77a, and the Securities Exchange Act of 1934, 15 U.S.C.A. § 78a, contained broad exemptions for municipal securities. SEC Staff Report on the Municipal Securities Market, [1993-2001 Transfer Binder] Fed. Sec. L. Rep. P (CCH) ¶ 85,217 (Sept. 3, 1993). The Commission has brought enforcement actions against Orange County, California, for failing to disclose risks of the County's investment pool and financial condition and the City of Syracuse, New York, for falsely claiming a surplus for its general and debt service funds. SEC REPORT, *supra* note 30, at 31, 59-60. Recently, the SEC charged the City of Harrisburg, Pennsylvania, with securities fraud for misleading public statements. See Press Release, Securities and Exchange Commission, SEC Charges City of Harrisburg for Fraudulent Public Statements (May 6, 2-13), available at www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514194#.UuWoAvdpaSM. In 2013, the SEC charged State of Illinois for failing to inform investors about its underfunded pensions. See Press Release, Securities and Exchange Commission, SEC Charges Illinois for Misleading Pension Disclosures (March 11, 2013), available at www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513202#.UuWon_dpaSM.

⁹¹SEC REPORT, *supra* note 30, at 29.

⁹²*In re* City of San Diego, Cal., (Nov. 14, 2006), available at <http://www.sec.gov/litigation/admin/33-8751.pdf>.

⁹³*In re* State of New Jersey, (Aug. 18, 2010), available at <http://www.sec.gov/litigation/admin/33-9135.pdf>.

⁹⁴*Id.*; *In re* City of San Diego, Cal., (Nov. 14, 2006), available at <http://www.sec.gov/litigation/admin/33-8751.pdf>.

either public employee salaries or retirement benefits for private industry employees.⁹⁵ Several factors have precipitated this phenomenon. First, in good economic times there is an incentive to increase public employee compensation generally. Across-the-board expansionary programs curry favor with an electorate that generally fails to perceive their long-term cost. Even in good times, however, there is political pressure not to increase public sector wages, which are open to public scrutiny. This concern translates into increasing benefits the long-term cost of which is opaque. Increasing wages and salaries is far more obvious to the electorate than increasing benefits, a fact that is aggravated by the political-agency phenomenon.⁹⁶ In good times or bad, aspiring politicians in low-turnout municipal elections seek the substantial political power of public employees and their unions.⁹⁷ Especially in bad economic times, the weakness of electoral discipline for municipal government offices exacerbates the costs of political agency, leading to underfunding of retirement benefits. In addition, automatic cost-of-living adjustments without corresponding increases in contributions also lead to underfunding.⁹⁸ Increasing benefits without corresponding increases in contributions for whatever reason cannot be sustained in the long run.

The decline in the market value of assets following the financial crisis of 2008 has also contributed to underfunding public pensions. There is a strong correlation between the S&P 500 and the market value of public pension assets because pensions invest in a broad range of equities. Additionally, a plan can appear to be fully funded in a bull market. Thus, when funding ratios are high—creating the appearance that a plan is overfunded—there

⁹⁵See Thomas J. Healey, et al., *Underfunded Public Pensions in the United States: The Size of the Problem, the Obstacles to Reform and the Path Forward*, MRCBG FACULTY WORKING PAPER NO. 2012-08 25 (May 5, 2012) (“*Underfunded Public Pensions*”), available at http://www.hks.harvard.edu//ezp_site/storage/fckeditor/file/pdfs/centers-programs/centers/mrcbg/publications/fwp/MRCBG_FWP_2012_08-Healey_Underfunded.pdf:

While average state/local employee compensation tapered off a bit between 2009 and 2010 (and private sector compensation grew slightly), for more than a decade state/local employees benefited from more substantial increases in their compensation and saw less of a decline after the financial crisis and economic downturn of 2007 and 2008.

The widespread conversion of private employee retirement benefits from defined benefit to defined contribution plans has not tracked to the public sector.

⁹⁶See David A. Skeel, Jr. *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 690 (2012) (“Nearly every state fiscal crisis can be traced, at least in part, to the agency costs of political decision makers—that is, conflicts of interest between the incentives of the decision makers and the constituencies that they ostensibly represent.”); Levitin, *supra* note 83, at 1425-28 (discussing “political moral hazard”).

⁹⁷Skeel, *supra* note 96, at 690-93 (describing the distortions of the incentives of political decision makers who depend on the votes of public union employees).

⁹⁸See Healey, *supra* note 95, at 27-28. See also Johnson & Young, *supra* note 89, at 131 (“[A]t least three states . . . have sought to restrict cost-of-living adjustments (COLA) to benefits for current retirees.”).

will be political pressure to increase pension payouts. In a bear market, however, public pension plans cannot reduce promised benefits and are left with a reduced ratio of assets to obligations and an underfunded position.⁹⁹

Thirdly, the changing demographics of the United States exacerbate the underfunding of pensions. The American population is aging¹⁰⁰ and there are proportionately fewer taxpaying workers to support public pensions and the retirees who depend on them. As the burden of funding public pensions is shifted to a smaller population of workers, the costs of pensions will become unsustainable.¹⁰¹ Stockton's substantial retiree obligations are not unique among American state and municipal governments. Various sources have concluded that unfunded liabilities for such plans in the United States range from a high of \$4 trillion,¹⁰² down to \$1.38 trillion,¹⁰³ to a low of \$1.1 trillion.¹⁰⁴ Cumulative plan deficits are substantial regardless of the actuarial assumptions made,¹⁰⁵ and the percentage of funding of state pensions range from only four states at 95% or above to four states below a very low 55% of full funding.¹⁰⁶ According to the recent report by The Pew Center on the States, "a healthy pension system should be at least 80 percent funded" and thirty-four states were below that amount at the end of 2010.¹⁰⁷ A more recent study by Moody's Investor Service paints an even bleaker picture.¹⁰⁸ Beyond the simmering crisis in public pensions, state funding of retiree health

⁹⁹Healey, *supra* note 95, at 26-27.

¹⁰⁰*Id.* at 30 ("In 1980, 69% of Americans were under the age of 45; by 2009 that ratio had dropped to 61%. The U.S. Census Bureau projects that by 2050 this ratio will drop to a rate of 57.4%.").

¹⁰¹*Id.* ("The U.S. Social Security system serves as useful proxy for an analysis of the overall American support ratio. Social Security has seen its worker-to-recipient ratio decline from 16.5 to 1 in 1950 to a current ratio of 2.9 to 1"). See also Jonathan V. Last, *WHAT TO EXPECT WHEN NO ONE'S EXPECTING: AMERICA'S COMING DEMOGRAPHIC DISASTER* 27 (2013) ("Fewer working-age people supporting more retirees means that something will have to give: Either benefits will be scaled back, non-entitlement spending cut, or taxes raised.").

¹⁰²*State and Local Government Defined Benefit Pension Plans*, U.S. SENATE COMMITTEE ON FINANCE (January 2012), available at http://www.hatch.senate.gov/public/_cache/files/ecfaf678-a3ec-45a4-3bca4fe9475d/Hatch%20Report%20-%20The%20Pension%20Debt%20Crisis%20that%20Threatens%20America.pdf.

¹⁰³THE PEW CENTER ON THE STATES, *THE WIDENING GAP UPDATE 1* (2012) (the "PEW REPORT"), available at <http://www.pewstates.org/research/reports/the-widening-gap-update-85899398241>.

¹⁰⁴Alicia H. Munnell, et al., *The Funding of State and Local Pensions: 2011-2015* (May 2012), available at http://crr.bc.edu/wp-content/uploads/2012/05/slp_24.pdf. (The shortfall of \$1.1 trillion is based on the present assumption of an 8% discount rate. Lower projected rates of return lead to projection of greater unfunded deficits.)

¹⁰⁵Resolution of what should be the appropriate discount rate will not be attempted here. For a discussion of the competing concerns see SEC REPORT, *supra* note 30, at 86-88.

¹⁰⁶See PEW REPORT, *supra* note 103, at 2.

¹⁰⁷*Id.*

¹⁰⁸See *Adjusted Pension Liability Medians for US States: New Measures Highlight Varying Affordability*, MOODY'S INVESTORS SERV. (June 27, 2013), available at https://www.moodys.com/research/Moodys-New-state-adjusted-pension-liabilities-show-wide-range-of-PR_276663. See also Susan E. Cancelosi, *Vebas to the Rescue: Evaluating One Alternative for Public Sector Retiree Health Benefits*, 42 J.

benefits is even weaker.¹⁰⁹ Under any view of the situation the retirement plans of many states and municipalities are insolvent and the extent of that insolvency is substantial.¹¹⁰

Notwithstanding widespread public pension underfunding, extensions of municipal finance continue unabated¹¹¹ and at relatively low rates of interest.¹¹² The fact that states cannot seek bankruptcy relief may contribute to the market's nonchalance. The policy of the United States Federal Reserve Board known as "quantitative easing"¹¹³ has done much to keep all interest rates low by historical standards.¹¹⁴ Finally, the redistributive effects of federal government spending stabilize municipal economies and thus reduce the risk of default.¹¹⁵ Direct grants to state and local governments as well as payments to the elderly, those on public assistance, and the disabled—what Adam Levitin describes as fiscal federalism—provide municipal residents with the wherewithal to pay taxes and thus tide cities as well as themselves through economic crises.¹¹⁶ Even with these subsidies for municipal finance,

Marshall L. Rev. 879, 880-81 (2009) ("Most [government employers] have financed retiree health benefits on a pay-as-you-go basis, with no assets set aside for future expenses.").

¹⁰⁹ See PEW REPORT, *supra* note 103, at 6. See also SEC REPORT, *supra* note 30, at 88 ("A recent study found that as of fiscal year 2010, only 5% of the \$660 billion liability for state retirees' health care and other non-pension benefits had been funded.").

¹¹⁰ See Skeel, *supra* note 26, at 1076 ("In the current environment, many states' balance sheets dramatically understate the extent of their liabilities."); Healey, *supra* note 95, at 31 ("[T]he assets and liabilities of public pension plans have historically been kept off the statements of net assets (or balance sheets) of public pension plan sponsors.").

¹¹¹ Municipal bond issues totaled \$151.1 billion in 2012 and \$83.3 billion through only the first quarter of 2013. See US Bond Market Issuance spreadsheet, *supra* note 75.

¹¹² See Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform*, 34 CARDOZO L. REV. 1455, 1460 (2013) ("Despite these developments [e.g., growth in volume and complexity of municipal securities, increased dispersal of investors, and rate volatility], the conventional wisdom respecting risk and municipal securities has not changed much over the years."). But see Skeel, *supra* note 26, at 1069 ("State and municipal bond markets . . . appear to distinguish fairly effectively between troubled and less troubled states."); Mary Williams Walsh, *Cost of Public Projects Is Rising, and Pain Will Be Felt for Years*, NEW YORK TIMES DEALBOOK (June 26, 2013), available at http://dealbook.nytimes.com/2013/06/26/bill-for-public-projects-is-rising-and-pain-will-be-felt-for-years/?_php=true&_type=blogs&_r=0 (last accessed June 27, 2013) ("States and cities across the nation are starting to learn what Wall Street already knows: the days of easy money are coming to an end.").

¹¹³ ET Bureau, *ET in the Classroom: Quantitative Easing II*, THE ECONOMIC TIMES (Nov. 2, 2010), available at http://articles.economictimes.indiatimes.com/2010-11-02/news/27632554_1_capital-flows-capital-inflows-economy.

¹¹⁴ See Morgan Ricks, *A Regulatory Design for Monetary Stability*, 65 VAND. L. REV. 1289, 1315 (2012) (discussing Federal Reserve's effecting of monetary expansion through quantitative easing in 2011 that led to "risk-free rates [that were] remarkably low by historical standards").

¹¹⁵ See Richard C. Schragger, *Citizens Versus Bondholders*, 39 FORD. URB. L.J. 787, 798 (2012) ("Local governments receive direct aid from the federal government. More important is the aid that flows to individuals through federal social welfare programs. The rise of the social welfare state means that economic downturns do not necessarily lead to economic collapse.").

¹¹⁶ See generally Levitin, *supra* note 83, at 1406-19.

the secondary market in municipal securities demonstrates that all municipal debt is not created equal and that the market is waking to previously ignored risks.¹¹⁷ One might expect the risk premium to increase for cities in states where bondholders receive less than retirees in bankruptcy, but this so far has not happened.

Regardless of the depth of the market for public finance, the effect of a non-pro rata treatment of municipal pension obligations remains unclear. Can a plan that is inconsistent with either bankruptcy or state-law fairness be crammed down over the objection of an impaired class? Are there reasons why such an impaired class might nonetheless vote for a plan that provides such treatment?

C. RISK REMAINS

A single feature ties together what appear to be three irreconcilable phenomena: (1) incomplete disclosure of municipal finance risk yet rare SEC enforcement actions; (2) continued issuance of municipal securities but with low rates of interest; and (3) continuing purchases of municipal securities notwithstanding weaker forms of credit enhancement and looming municipal insolvency. What keeps this dysfunctional market going is low rates of default.¹¹⁸ As long as investors are ultimately paid, no one is greatly concerned about the many defects in the market for municipal securities. No harm, no foul, so to speak.

1. *Where Risk Resides*

Christine Sgarlata Chung has described the dark side of this seemingly idyllic state of affairs.¹¹⁹ There is a cost to this bondholder protection; ultimately someone must pay. And it is taxpayers and recipients of municipal services who bear the primary risk of financial distress when bondholders are largely impervious to default. When compared with corporate borrowers and their shareholders, the borrowing decisions and sources of repayment of municipalities are less flexible and the exit rights of their taxpaying residents are much more expensive. Many of the reasons for continuing municipal borrowing are structural; cities do not have the power to decide not to supply

¹¹⁷See, e.g., *Investors in Detroit Municipal Bonds Are Nervous*, DETROIT FREE PRESS (December 18, 2011), available at <http://www.municipalinsider.com/investors-in-detroit-municipal-bonds-are-nervous/> (“Detroit’s general obligation bonds have recently traded at the deepest discount—some around 67 cents on the dollar.”)

¹¹⁸See James Spiotto, et al., MUNICIPALITIES IN DISTRESS? HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES 10 (2012):

Since 1839, there have been less than 11,000 municipal (local government) defaults. Almost half of these occurred between 1929-1937 in the Great Depression. The number of defaults is quite small given that presently there are over 89,000 local governments (municipal and state entities) in the United States of America.

¹¹⁹See Chung, *supra* note 112.

basic services such as fire and police protection, water and sewer services, or public education.¹²⁰ The countercyclical nature of demands on municipal services also challenges municipal solvency. When economic conditions are at their worst, more of a city's residents seek its services for assistance with shelter and security.¹²¹ Municipalities also have inelastic sources of ordinary revenue—real estate taxes and user fees—and very restricted powers to sell assets.¹²² Most limiting of all is the high cost to taxpayers of escaping increasing tax burdens imposed to pay municipal securities;¹²³ they must sell their real property, an expensive proposition whether it is a home or business location.¹²⁴ The upside to municipalities of negligible risk to bond purchasers is lower interest rates; the downside is a heavy burden on an issuer's taxpayers and other stakeholders, who can neither diversify against risk nor insulate themselves from it.¹²⁵ The combination of legal and political regimes that substantially eliminate the ability of a municipality to default have effectively shifted the risk of financial distress from bondholders to others including employees, retirees, service recipients, and taxpayers. Yet, it was the question of continuation of bondholder protection that Stockton's bankruptcy raised. If Stockton's plan leaves retirees unimpaired then bondholders or taxpayers stand to lose. Bankruptcy is a zero sum game. The question is where the risk of insolvency ultimately comes to rest.

¹²⁰See Schragger, *supra* note 115, at 795 (“[L]ocal governments are compelled by state mandates to provide certain services. Unlike firms, cities cannot restructure those basic obligation.”); Chung, *supra* note 112, at 1481-82 (“Because the size, scope and timing of governmental projects may be dictated by community needs or legal requirement, municipal securities issuers may not have much flexibility respecting the purpose, timing or size of securities offerings.”).

¹²¹See Levitin, *supra* note 83, at 1407-08 (discussing countercyclical demands on state services that apply equally to cities).

¹²²Chung, *supra* note 112, at 1482 (“Unlike corporations, municipal securities issuers cannot enter or exit businesses to generate revenues, nor can they easily leverage or sell assets to raise funds for debt service obligations.”).

¹²³Alternatively, a municipality may choose not to increase taxes but instead reduce services. Economically, the impact on taxpayers is the same. See Candy Neal, *Officials Worry Bills Could Drop Revenue*, THE HERALD, January 30, 2013, at 3, available at duboiscountyherald.com/b/officials-worry-bills-could-drop-revenue.

¹²⁴Chung, *supra* note 112, at 1483-84:

Once a taxpayer 'buys in' to the municipal enterprise through the purchase of residential real estate . . . her choices are limited. She must pay governmental levies whether or not she agrees with a particular expenditure. . . . If the taxpayer is not happy with this state of affairs, she may be left with having to sell her real estate and move out of town. This is likely to involve significant transaction costs, especially when real estate markets are in turmoil.

¹²⁵Jim Christie, *Stockton Taxpayers Want Bigger Role in California City's Bankruptcy Case*, Reuters (Jun. 28, 2013), available at <http://www.reuters.com/article/2013/06/29/us-stockton-bankruptcy-taxpayers>. Some taxpayers of Stockton belatedly reached this conclusion and an ad hoc working group of taxpayers appeared in the case. See Notice of Appearance and Request for Special Notice Pursuant to Federal Rule of Bankruptcy Procedure 2002 at 1, *In re City of Stockton*, No. 12-32118 (June 28, 2013), ECF No. 970.

Modern portfolio theory explains that risk can be reduced by improving the quality, liquidity, and diversification of assets.¹²⁶ Pension payments may be the only source of income for retirees and, given their higher ages, they have fewer alternative sources of income than, say, current municipal employees. Taxpayers as well as other recipients of municipal services can address the negative effects of risk by moving from a municipality when the cost or level of services changes for the worse. Employees can, of course, change jobs. But it is more difficult for retirees, taxpayers, or employees to reduce risk given than it is for bondholders given the need of the former to live in a particular place and the costs of getting or changing jobs. Such individuals find it difficult to diversify.

It is bondholders as a class who have the greatest opportunity to reduce the risk of nonpayment by an issuer. Prudent bondholders will examine the financial quality of the issuer¹²⁷ and diversify their investments across a wide portfolio. Bond underwriters can spread the cost of evaluating the soundness of an issuer more efficiently than individual investors. Similarly, underwriters can require credit insurance, which is not available to individuals. Yet, only three sorts of municipal stakeholders—retirees, employees, and bondholders—clearly have standing in bankruptcy; taxpayers and service recipients do not. Members of municipal government could protect these stakeholders, but agency costs and the general lack of electoral discipline make this uncertain.

Chung argues that given the current state of affairs in which financial risk is largely allocated to taxpayers, the federal regulatory scheme for municipal securities should be enhanced to address their risks: “[A] system of regulation which systemically externalizes known risks and costs experienced by literally millions of taxpayer stakeholders reflects questionable regulatory policy.”¹²⁸ She instead would have federal securities laws modified to bring taxpayers into the equation, principally by applying a fiduciary standard to underwriters and the relevant government officials involved in issuing municipal securities.¹²⁹ These duties would run not only to investors but also to taxpayers.¹³⁰ Together with other regulatory reforms, Chung believes that

¹²⁶See Hilary J. Allen, *Monday Market Fund Reform Viewed Through a Systemic Risk Lens*, 11 J. Bus. & Sec. L. 87, 96 (2010).

¹²⁷But see *supra* text accompanying notes 81–83 (describing opacity of secondary municipal bond market).

¹²⁸Chung, *supra* note 112, at 1519.

¹²⁹See generally *id.* at 1520–24.

¹³⁰*Id.* at 1520–21:

I would require these stakeholders [e.g., underwriters and government officials] to 1) comply with fiduciary duties of care and loyalty when providing advice, considering the benefits, risks and cost of funding plans over both the short and long term, and 2) place the short and long term interests of issuers before those of the stakeholder owing the fiduciary obligation.

the risk of municipal insolvency will be better identified and more openly (if not more fairly) allocated.¹³¹ But the fact remains that the current state of affairs obtains in contemporary municipal bankruptcies. The question is whether a plan of adjustment that turns none, some, or all of that risk back to investors and away from taxpayers, employees, and retirees meet the standard of bankruptcy fairness and thus may be crammed down.

2. Political Reallocation

Procedural fairness can be considered as entailing transparent allocation of risk.¹³² As Clayton Gillette argues, however, the issue of procedural fairness cannot be entirely subsumed in the bankruptcy process.¹³³ An initial allocation of risk and its subsequent reallocation in bankruptcy, even if that reallocation comports with substantive fairness, may not be procedurally fair. Substantive fairness—as used in this article—does not address the initial allocation of risk. An unfair allocation of risk—initial unfairness—may precede a municipality's chapter 9, thus rendering the bankruptcy process, no matter how procedurally fair, the means by which initial unfairness is granted judicial imprimatur. The city of Central Falls, Rhode Island, is Gillette's prime example of initial unfairness distorting the application of chapter 9.

Compared with the treatment of secured creditors under other chapters of the Bankruptcy Code, secured bondholders receive special solicitude under chapter 9. Section 922(d)¹³⁴ exempts from the automatic stay payment of "special revenues"¹³⁵ contractually pledged to bondholders by a municipality.¹³⁶ Elsewhere the Bankruptcy Code provides that prepetition payments to bondholders cannot be avoided as preferences.¹³⁷ Similarly, state law statutory liens running in favor of bondholders are generally unavoidable.¹³⁸ Nor can the claim of a revenue bondholder be bifurcated between unsecured and secured portions as would be the case in any bankruptcy outside of chapter 9.¹³⁹ Collateralized municipal securities are well protected by bankruptcy

¹³¹*Id.* at 1524 ("[A] fiduciary standard has the potential to improve the quality of deliberations associated with municipal funding plans, to ensure loyal conduct from stakeholders . . . and to (at least) reduce the frequency and severity of harms associated with a lack of due care and/or loyalty breaches.").

¹³²See Bruce Chapman, *Allocating the Risk of Subjectivity: Intention, Consent, and Insurance*, 57 *TORONTO L. REV.* 315, 329 (2007).

¹³³Gillette, *supra* note 89.

¹³⁴11 U.S.C. § 922(d) ("Notwithstanding section 362 of this title and subsection (a) of this section, a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues.").

¹³⁵See *supra* text accompanying notes 85-86.

¹³⁶For the history of this provision see Spiotto, *supra* note 118, at 54-56.

¹³⁷11 U.S.C. § 926(b) ("A transfer of property of the debtor to or for the benefit of any holder of a bond or note, on account of such bond or note, may not be avoided under section 547 of this title.").

¹³⁸11 U.S.C. § 545.

¹³⁹11 U.S.C. § 928(a) ("Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, special revenues acquired by the debtor after the commencement of the case shall remain

law.

The risk to retirees, employees, and unsecured creditors of nonpayment or to taxpayers is increased because of the heightened protection for secured bondholders. The protections for revenue bonds exist regardless of whether it was wise to issue the bonds in the first place. Taxpayers, employees, and retirees could have examined bond issues to see if they were collateralized or otherwise secured by statutory liens but the costs to individuals greatly exceeds any reasonably expected personal benefit. Thus, the combination of state legislation and bankruptcy law shifts virtually all risks from revenue bondholders to other stakeholders. Initial allocations of risk set the table for application of the standard of bankruptcy fairness.

What if—after bonds have been issued and sold as unsecured general bonds—a state purposely combines the bankruptcy protection afforded statutory liens with the particular unavailability of liens against municipalities? And what if it does so shortly before one of its cities files under chapter 9? Rhode Island carried out such an *ex post* reallocation of “initial” risk from previously unsecured bondholders to employees, retirees, and taxpayers.¹⁴⁰ Immediately prior to the Central Falls bankruptcy, Rhode Island simply converted unsecured general obligation bonds to secured revenue ones through legislative fiat.¹⁴¹ The result was, as Gillette observes, “to grant the bondholders within the state priority over other claimants . . . such as city employees or pensioners . . .”¹⁴² This effect of this eve-of-bankruptcy unavoidable transfer was stark: previously unsecured general obligation bondholders received 100% of their claims while pension claims received 55% of theirs and municipal services to taxpayers were reduced.¹⁴³ This application of the Bankruptcy Code to Central Falls was straightforward; it met the standards of both bankruptcy and state-law fairness. Initial fairness and substantive fairness are inextricably intertwined and after-the-fact reallocations of initial risk strike most people as inherently unfair.¹⁴⁴ Yet, such non-bankruptcy reallocations are clearly protected by the Tenth Amendment.

subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.”).

¹⁴⁰See R.I. GEN. LAWS § 45-12-1(a) (2011) (“The faith and credit, ad valorem taxes, and general fund revenues of each city, town and district shall be pledged for the payment of the principal of, premium and the interest on, all general obligation bonds and notes of the city or town whether or not the pledge is stated in the bonds or notes, or in the proceedings authorizing their issue and shall constitute a first lien on such ad valorem taxes and general fund revenues.”).

¹⁴¹Rhode Island is not the only state to secure general obligation bonds with a statutory lien. See generally Spiotto, *supra* note 118, at 57-60.

¹⁴²Gillette, *supra* note 89, at 1143-44.

¹⁴³*Id.* at 1144.

¹⁴⁴For an alternative (or supplemental) analysis of the political and social dynamics that lead state and municipal governments to treat holders of municipal securities with greater solicitude than citizens and certain other creditors, see Schragger, *supra* note 115, at 799-803 (describing concerns about subsequent

Nothing like the last-minute statutory transformation of general obligation bonds into revenue bonds has taken place in California. As noted above, California law provides CalPERS with a statutory lien to secure a municipality's pension termination liability.¹⁴⁵ There is no lien if a municipality does not terminate its pension management agreement with CalPERS, and even that lien secures only underfunded pension obligations. To the extent pension obligations are impaired inside bankruptcy, there is no lien. It is even conceivable that a municipality could find itself overfunded vis-à-vis CalPERS if pension obligations are sufficiently reduced, in which case it would be due a refund.¹⁴⁶ The question is thus whether vested municipal pension obligations can be reduced in bankruptcy. Can impairment of pension claims meet the requirement of state-law fairness? Would conforming to state-law fairness violate bankruptcy fairness?

In the chapter 9 bankruptcy of the City of Vallejo, CalPERS took the position that vested pension benefits were immune from modification even in chapter 9, and that a municipality's contract with it could not be rejected.¹⁴⁷ In other words, and not surprisingly, CalPERS argued that state-law fairness trumped bankruptcy fairness. While the court in *Vallejo* never ruled on CalPERS's second assertion, it held that federal bankruptcy law preempted inconsistent California law with respect to rejection of collective bargaining agreements that had created the pensions Vallejo proposed to reduce.¹⁴⁸ In other words, bankruptcy fairness trumped state-law fairness. The court's reasoning was straightforward: federal bankruptcy law preempts California labor law to the contrary.¹⁴⁹ Cities have the power to reject executory contracts notwithstanding state efforts to impose its law on the bankruptcy process.¹⁵⁰

CalPERS, like other stakeholders, can expect to be exposed to the risk of nonpayment. Coupled with the *Stockton* court's conclusion in *Stockton II* that the obligation to pay retirees' pensions is not an executory contract,¹⁵¹ it seems unlikely that CalPERS would succeed in asserting a termination lien on account of impairment of retiree claims. Yet, one can also question

lack of access to credit markets, financial contagion, hostility toward public employee unions and redistributive spending).

¹⁴⁵See *supra* text accompanying note 18.

¹⁴⁶See CAL. GOV. CODE § 20577.

¹⁴⁷See Objection by California Public Employees' Retirement System to the City of Vallejo's Motion for Approval of Rejection of Collective Bargaining Agreements at 9-12, *In re City of Vallejo*, No. 08-26813, (Bankr. E.D. Cal. Dec. 11, 2008), ECF No. 312.

¹⁴⁸See *In re City of Vallejo*, 403 B.R. 72, 77 (Bankr. E.D. Cal. 2009), *aff'd sub nom.* Int'l Bhd. of Elec. Workers v. City of Vallejo (*In re City of Vallejo*), 432 B.R. 262 (E.D. Cal. 2010).

¹⁴⁹*Id.* at 77.

¹⁵⁰*Id.* at 76-77. See also Int'l Bhd. of Elec. Workers v. City of Vallejo (*In re City of Vallejo*), 432 B.R. at 270.

¹⁵¹*Stockton II*, 478 B.R. at 22.

whether a plan could be crammed down if it did *not* impair the unfunded portion of claims of retirees and also included assumption of Stockton's contract with CalPERS. Could such a plan meet the test of bankruptcy fairness? If the results in *Central Falls* are a model, a municipality may choose to take up or forgo use of bankruptcy to implement whichever aspect of substantive unfairness it chooses. A municipality that privileges bankruptcy fairness over state-law fairness or one that proposes the opposite appears equally likely to be able to confirm a plan. Whether such should be the case is a different matter.¹⁵²

III. ASSUMPTION AS A GAME CHANGER

The power to assume (or reject) executory contracts under section 365 of the Bankruptcy Code is crucial to maximizing value for creditors.¹⁵³ Maintaining contracts by which the debtor acquires necessary goods or services is vital to its continued operation. Assumption permits a debtor and the contract counterparty to continue their relationship notwithstanding the bankruptcy. Conversely, in some circumstances continuing to perform a contract may be burdensome to a debtor; rejection brings the contract to an end and in return gives the counterparty a claim for damages.¹⁵⁴

Exercising the power to assume or to reject in a municipal bankruptcy raises several questions. First, since Congress failed to define "executory contract," the court must resolve whether a municipality's agreements with its retirees are executory contracts. The court in *Stockton II* concluded that they were not. As the bankruptcy court observed in *Stockton IV*, municipalities may pay claimants apart from assumption of an executory contract but such payment may create subsequent confirmation-related issues. But what of executory contract counterparties? Does assumption effectively foreclose consideration of substantive fairness? Second, if retiree benefits are part of an executory contract, the court must choose and apply a standard to any motion to assume them. How much deference should the court pay to the city's judgment when assumption of certain contracts may substantially constrain the terms of a plan? Once a contract has been assumed, it is treated as an administrative expense and afforded priority treatment, thus limiting subsequent choices.¹⁵⁵ Assumption would greatly limit options in any plan and would raise the "creeping confirmation" issue noted by the court in *Stockton IV*. Could preconfirmation assumption be substantively unfair?

¹⁵²See *infra* text accompanying notes 236-243.

¹⁵³See *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984); *Philadelphia Co. v. Dipple*, 312 U.S. 168, 173-74 (1941).

¹⁵⁴See generally 3 ALAN N. RESNICK & HENRY J. SOMMER, EDs., *COLLIER ON BANKRUPTCY* ¶¶ 365.10 (16th ed. 2013) (describing effects of assumption and rejection).

¹⁵⁵11 U.S.C. §§ 365(g)(2)(A), 503(b), 507(a)(2), 943(b)(5).

A. THE DEFINING QUESTION

The failure of the Bankruptcy Code to define "executory contract" has generated multiple judicial decisions and reams of academic commentary. Most courts have adopted the Countryman definition that an executory contract exists only where both the debtor and its counterparty have remaining unperformed material duties.¹⁵⁶ Others have been less concerned with the need for formal reciprocity of the potential for material breach than with the advantage assumption might bring the debtor's estate and creditors, the so-called functional test.¹⁵⁷ Stockton is in the Ninth Circuit but the Ninth Circuit's understanding of "executory contract" is unclear. In the early *Texscan* decision, it expressly adopted the Countryman definition and the requirement that both contract parties be capable of materially breaching for a contract to count as executory.¹⁵⁸ More recently, however, the Ninth Circuit observed that "[a] contract is executory, and therefore assumable under § 365, only if one party's failure to perform its obligation would excuse the other party's performance."¹⁵⁹ Mutuality of executory obligations was not required; the functional test prevailed.

Retiree pension benefits that are part of a collective bargaining agreements would be part of an executory contract from a functional perspective subject to proving their assumption would benefit the municipality. They would not be part of an executory contract under the Countryman test, however, because retirees owe no further duties to their former employer; they cannot breach. Affected retirees would have only a claim under the Countryman definition.¹⁶⁰ Even then, their claims should be bifurcated between what has been funded by a city's contributions to an administrator like CalPERS with an unsecured remainder¹⁶¹ and only the unsecured portion can be impaired.

B. A MATTER OF JUDGMENT

In contrast with settlement of claims, assumption of an executory con-

¹⁵⁶Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). See *RCI Tech. Corp. v. Sunterra Corp.* (*In re Sunterra Corp.*), 361 F.3d 257, 264 (4th Cir. 2004) (applying Countryman test).

¹⁵⁷See, e.g., Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989); *Chattanooga Mem'l Park v. Still* (*In re Jolly*), 574 F.2d 349, 350-51 (6th Cir. 1978).

¹⁵⁸*Commercial Union Ins. Co. v. Texscan Corp.* (*In re Texscan Corp.*), 976 F.2d 1269, 1272 (9th Cir. 1992).

¹⁵⁹*Zurich Amer. Ins. Co. v. Int'l Fibercom, Inc.* (*In re International Fibercom, Inc.*), 503 F.3d 933, 941 (9th Cir. 2007) (citing *Texscan*).

¹⁶⁰*Stockton II*, 478 B.R. at 27 ("The plaintiffs' asserted right to require the City to continue to pay for health benefits based on their prebankruptcy contractual rights are 'claims.'").

¹⁶¹See Skeel, *supra* note 96, at 698 ("It is quite likely that a court would conclude that pension beneficiaries do have a property interest, but only to the extent of the funds the state [or municipality] has set aside for payment. The unfunded portions would be treated as general unsecured obligations.").

tract remains subject to bankruptcy court approval in chapter 9. Section 901 of the Bankruptcy Code incorporates section 365, which governs assumption and rejection of executory contracts.¹⁶² Whatever standard of judicial review applies to assumption of executory contracts outside chapter 9 equally applies to municipal decisions to assume or reject.¹⁶³ While the contours of the standard of judicial review vary among the circuits, the Ninth Circuit in *Pomona Valley Medical Group*¹⁶⁴ provides perhaps the most deferential guideline: a bankruptcy court “need engage in only a cursory review” of a decision to reject an executory contract.¹⁶⁵ Indeed, the debtor is afforded presumptions of acting prudently, with sufficient information, in good faith, and with honesty.¹⁶⁶ Only if a decision to reject is “so manifestly unreasonable” that it must have been the result of “bad faith, or whim or caprice” is the court warranted in denying the debtor’s motion.¹⁶⁷ The breadth of the Ninth Circuit’s holding on rejection leaves no reason to believe that a less deferential standard would be applied to a debtor’s decision to assume, and other courts have held that decisions to assume are subject to the same degree of deference afforded a decision to reject.¹⁶⁸ Nothing in the Ninth Circuit’s understanding of section 365 would preclude Stockton from seeking to assume its agreements with CalPERS and its bargaining units.

C. TIMING IS EVERYTHING

Given the powerful effect of assumption of significant executory contracts on any subsequent plan, might the court simply defer decision until the hearing on confirmation? Section 365(d)(2) of the Bankruptcy Code provides that a debtor or trustee may seek assumption of an executory contract “at any time before the confirmation of a plan.”¹⁶⁹ Yet, the debtor need not take action before confirmation because section 1123(b)(2) provides for assumption as part of a plan of reorganization.¹⁷⁰ It would be a rare municipal bank-

¹⁶²11 U.S.C. § 901(a).

¹⁶³See *Moran v. City of Cent. Falls*, 475 B.R. 323, 332 (D.R.I. 2012) (affirming decision of bankruptcy court permitting municipal debtor to reject executory contract and observing that judicial review of decision to reject is “limited to a determination whether such decision was made with sound business judgment.”)

¹⁶⁴*Agarwal v. Pomona Valley Med. Grp., Inc. (In re Pomona Valley Medical Grp., Inc.)*, 476 F.3d 666 (9th Cir. 2007).

¹⁶⁵*Id.* at 670.

¹⁶⁶*Id.*

¹⁶⁷*Id.*

¹⁶⁸See, e.g., *In re Natco Indus., Inc.*, 54 B.R. 436, 440 (Bankr. S.D.N.Y. 1985); *In re Old Carco LLC*, 406 B.R. 180, 187-88 (Bankr. S.D.N.Y. 2009); *In re Hawker Beechcraft, Inc.*, 486 B.R. 264, 275-77 (Bankr. S.D.N.Y. 2013).

¹⁶⁹11 U.S.C. § 365(d)(2) (“In a case under chapter 9 . . . the trustee may assume or reject an executory contract . . . of the debtor at any time before the confirmation of a plan . . .”).

¹⁷⁰11 U.S.C. § 1123 (b) (“Subject to subsection (a) of this section, a plan may . . . (2) subject to section 365 of this title, provide for the assumption, rejection, or assignment of any executory contract or

ruptcy where a long-standing pension administration contract or collective bargaining agreement would need to be assumed before confirmation. Unlike commercial lessors or licensors of intellectual property, plan administrators and municipal employees are unlikely to have better deals in the offing.

The expression "creeping confirmation" mentioned in *Stockton IV*¹⁷¹ dates to 1983 and the Fifth Circuit's decision in the *Braniff*¹⁷² case. Together with its subsequent decision in *Continental*,¹⁷³ the Fifth Circuit deemed at least some attempts to engineer preconfirmation sales of substantially all of a debtor's assets under section 363 of the Bankruptcy Code to amount to a *sub rosa* plan of reorganization without the protections afforded dissenting creditors under section 1129. The scope of the transaction proposed in *Braniff* was exceptional. Not only did the debtor seek approval of a sale of nearly all of its assets, the purchase price was travel scrip, unsecured notes, and a share of the profits in the purchasing airline.¹⁷⁴ The underlying purchase agreement went on to require that secured creditors vote their deficiency claims as directed by the unsecured creditors' committee and for a release of all claims against the officers and directors of the debtor.¹⁷⁵ The court had little difficulty concluding that an order approving the wide scope of the agreement went beyond section 363 and amounted to a reorganization without voting.¹⁷⁶ *Braniff* did not, however, establish a standard of judicial review for bankruptcy sales. It held only that such all-encompassing proposals were outside the scope of section 365.

In 1986 the Fifth Circuit also reversed approval of the sale transaction in *Continental*; however, both the scope of the transaction and the nature of the court's concerns were more limited in the later case. In the fewer than three years between *Braniff* and *Continental*, the Second Circuit had stated in *Lionel*¹⁷⁷ a deferential standard of judicial review for bankruptcy sales. On the one hand, the Second Circuit concluded that the bankruptcy court did not have unfettered discretion to approve sales. On the other hand, it also noted that sales of substantially all of the debtor's assets need not proceed through a confirmed plan.¹⁷⁸ The appropriate standard of judicial review was simply

unexpired lease of the debtor not previously rejected under such section); see also 11 U.S.C. § 901(a) (incorporating § 1123(b) into chapter 9).

¹⁷¹ *In re City of Stockton*, 486 B.R. 194 (Bankr. E.D. Cal. 2013).

¹⁷² *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935 (5th Cir. 1983).

¹⁷³ *Inst. Creditors of Cont'l Air Lines, Inc. v. Cont'l Air Lines, Inc. (In re Cont'l Air Lines, Inc.)*, 780 F.2d 1223 (5th Cir. 1986).

¹⁷⁴ *Braniff Airways*, 700 F.2d at 939. The sale agreement also directed distribution of the scrip. *Id.*

¹⁷⁵ *Id.* at 939-40.

¹⁷⁶ *Id.* at 940.

¹⁷⁷ *Comm. of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2nd Cir. 1983).

¹⁷⁸ *Id.* at 1069-71.

“some articulated business justification, other than appeasement of major creditors,”¹⁷⁹ although the court’s analysis suggested that factors like the proportion of value of the assets to be sold to the whole, the lapse of time since filing, and the timing of a plan, and “the effect of the proposed disposition on future plans of reorganization” should be taken into account.¹⁸⁰ The Fifth Circuit in *Continental* acknowledged the danger of a *sub rosa* or creeping plan of reorganization and ultimately reversed the decision by the district court approving a sale but only because the lower court had failed to address the substantive objections of the parties opposing the deal.¹⁸¹ For debtors that seek preemptive assumption, the Fifth Circuit suggested a bankruptcy court may do something other than simply deny approval of a transaction that overreaches section 363. A bankruptcy court instead can fashion “protective measures” along the lines of plan confirmation.¹⁸² Deferral of judicial approval *until* confirmation would be a simple protective measure.

Since *Braniff*, courts have regularly acknowledged that “creeping confirmation” is to be avoided but have rarely found it a sufficient ground to reject a proposed transaction supported by virtually any business reason.¹⁸³ Perhaps debtors have learned a lesson and are simply not seeking to use overly broad assumption motions because of concerns about challenges to confirmation. In any event, even the Fifth Circuit gave this concern short shrift when it came to a debtor’s motion to assume a lease as opposed to a sale of assets.¹⁸⁴ Yet the Ninth Circuit has not addressed the issue, leaving it open for litigation had Stockton sought prior to confirmation to assume unmodified collective bargaining agreements and its contract with CalPERS.

On the one hand, the comparatively light review afforded a debtor’s decision to assume an executory contract might tempt a municipality to assume pension-related contracts if its government prefers the class of local employees and retirees over distant bondholders. On the other hand, lack of urgency for assumption of such contracts—a city’s employees are unlikely to leave so long as their contracts have not been rejected—and the ease of deferring consideration of a motion until the hearing on confirmation make it unlikely a city will seek to jump the gun. After all, the good will of the court and future purchasers of municipal securities will also weigh in the balance.

¹⁷⁹*Id.* at 1070.

¹⁸⁰*Id.* at 1071.

¹⁸¹*Continental*, 780 F.2d at 1228.

¹⁸²*Id.*

¹⁸³See Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 BANKR. DEV. J. 37, 52-54 (1999).

¹⁸⁴See *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1312 (5th Cir. 1985) (“We do not doubt that a debtor can assume a lease under its original, prebankruptcy terms without creating a *sub rosa* plan of reorganization, so long as such an assumption is a valid exercise of a debtor’s business judgment.”).

IV. CONFIRMATION

Confirmation of a chapter 9 plan of adjustment is governed by the relevant sections of Chapter 11.¹⁸⁵ Not surprisingly, if the rights of a class of creditors are not impaired, confirmation of a plan of adjustment raises no legal issues. Indeed, the individual members of such a class do not vote.¹⁸⁶ Similarly, confirmation is not difficult when all impaired classes vote to accept a plan. The considerable utility of bankruptcy reorganization or adjustment lies in its ability to bind dissenters; creditor consent to impairment need not be unanimous. Creditors vote by class and a class is deemed to have voted for a plan if more than one-half of its members holding two-thirds of the debt vote in favor of the plan.¹⁸⁷ The extraordinary power of plan confirmation lies in its power to bind non-consenting members of a class when the class votes in favor of the plan.¹⁸⁸ Without the Bankruptcy Clause or its consent, the rights of a minority cannot be affected by a majority.

A. CRAM-DOWN

The power of bankruptcy goes further yet. Even if all classes do not vote for a plan, it may nonetheless be confirmed by cram-down.¹⁸⁹ Several conditions must be satisfied for a plan of adjustment to be crammed down. First, the plan must comply with the incorporated requirements of section 1129(a).¹⁹⁰ Second, as in chapter 11, at least one class of impaired claims must have voted in favor of the plan.¹⁹¹ Third, the court must find that the treatment proposed by the plan is "fair and equitable" to members of the non-consenting class.¹⁹² Only bankruptcy fairness can justify a nonconsensual plan that impairs a creditor's legal rights, so it is not surprising that the cram-down provisions of bankruptcy law require heightened judicial solicitude for the rights of the members of a non-consenting class.¹⁹³

The requirement that a plan must be fair and equitable represents one-half of the test of bankruptcy fairness. The rule that a plan be fair and equitable focuses on allocating value that will be distributed under the plan to classes of creditors in a way that is consistent with bankruptcy priorities. A plan of adjustment must distribute the payments from a municipality in the

¹⁸⁵See 11 U.S.C. § 901(a), incorporating sections 1126(c), 1126(f), 1129(a)(2), 1129(a)(3), 1129(a)(6), 1129(a)(8), 1129(a)(10), 1129(b)(1), 1129(b)(2)(A), and 1129(b)(2)(B) of the Bankruptcy Code.

¹⁸⁶11 U.S.C. § 1126(f).

¹⁸⁷11 U.S.C. § 1126(c).

¹⁸⁸11 U.S.C. § 944(a)(3).

¹⁸⁹JOAN N. FEENEY, *BANKRUPTCY LAW MANUAL* § 11:64 (5th ed. 2013).

¹⁹⁰11 U.S.C. § 943.

¹⁹¹11 U.S.C. §§ 901(a), 1129(a)(10).

¹⁹²11 U.S.C. §§ 901(a), 1129(b)(1). See *infra* text accompanying notes 202–221.

¹⁹³David A. Skeel, Jr., *State Bankruptcy from the Ground Up*, in *WHEN STATES GO BROKE* 191, 199 (Peter Conti-Brown & David A. Skeel, Jr. eds. 2012).

order provided by the Bankruptcy Code or state-law priorities recognized by the Code. The well-known absolute priority rule is simply a function of applying the fair and equitable test. As Bruce Markell puts it, "Vertical expectations are the province of the fair and equitable rule." Thus, secured revenue bonds must be paid before unsecured general obligation bonds or unsecured pension obligations. Paying claims with state-law priorities that do not also enjoy Bankruptcy Code priority would violate the rule that payments under a plan that is crammed down must be fair and equitable.

Fourth, a plan may not "discriminate unfairly" if it is to be crammed down over the objection of a dissenting class. The rule against unfair discrimination represents the other half of the test of bankruptcy fairness. Combining both aspects of bankruptcy fairness, we see that while the fair and equitable requirement implements *vertical* expectations of creditors, the unfair discrimination requirement implements their *horizontal* expectations.¹⁹⁴ Unfair discrimination is particularly significant in chapter 9 because the Supreme Court first applied this requirement in a chapter IX case in 1940.¹⁹⁵ The prohibition of unfair discrimination makes it impossible to cram down a plan that treats differently creditors with the same bankruptcy priority. All unsecured creditors including holders of general obligation bonds as well as retirees, to the extent their benefits are unfunded, must receive the same net payments under a plan of adjustment. Bruce Markell suggests the following test for the presence of unfair discrimination:

[A] court should not confirm a nonconsensual plan, even if it provides fair and equitable treatment for all classes, when there is: (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class . . . or (b) . . . an allocation under the plan of materially greater risk to the dissenting class¹⁹⁶

Paying retirees a greater percentage of their unsecured claims than general obligation bondholders could not, without the consent of the class of bondholders, be confirmed.

Next, what is implicit in section 1129(a)(7) of the Bankruptcy Code¹⁹⁷ is

¹⁹⁴Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AMER. BANKR. L. J. 227, 247 (1998).

¹⁹⁵*American United Mutual Life Ins. Co. v. City of Avon Park*, 311 U.S. 138 (1940).

¹⁹⁶Markell, *supra* note 194, at 249.

¹⁹⁷11 U.S.C. § 1129:

- (a) The court shall confirm a plan only if all of the following requirements are met:
 - (7) With respect to each impaired class of claims or interests—

made explicit in chapter 9: a plan cannot be confirmed unless it “is in the best interests of creditors.”¹⁹⁸ The impossibility of liquidation of a municipality as an alternative to its reorganization entails this requirement and no plan that fails this test may be confirmed.¹⁹⁹ Finally, a sixth provision of chapter 9 must be satisfied: implementation of the plan cannot be prohibited by law.²⁰⁰

B. IN FOR A PENNY, IN FOR A POUND: TWO ASPECTS OF BANKRUPTCY FAIRNESS

The fairness at issue in chapter 9 is primarily substantive. Substantive fairness in bankruptcy is not a roving commission to right prebankruptcy wrongs.²⁰¹ Bankruptcy fairness is not about reallocating risk. Instead, it safeguards vertical and horizontal expectations with respect to priority by insuring a plan is both “fair and equitable” and does not “discriminate unfairly.” Creditors with a higher bankruptcy priority must be paid before those with a lower priority and with respect to those with the same priority, the plan must implement the principle of *pari passu*. Creditors of the same bankruptcy priority receive the same ratable distribution.²⁰² In other words, unless otherwise recognized by the Bankruptcy Code, state law priorities are preempted by bankruptcy fairness.²⁰³ If either aspect of the notion of bankruptcy fairness does not accord with a state’s preferred priorities, the state is free to withdraw its consent to municipal bankruptcy.

-
- (A) each holder of a claim or interest of such class—
- (i) has accepted the plan; or
 - (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date;

Section 901 does not incorporate this section because municipalities cannot be liquidated.

¹⁹⁸11 U.S.C. § 943(b)(7). See *infra* text accompanying notes 222-229.

¹⁹⁹See generally 6 ALAN N. RESNICK & HENRY J. SOMMER, EDs., COLLIER ON BANKRUPTCY ¶ 943.03[7][a] (16th ed. 2013):

A municipality cannot be liquidated, its assets sold, and the proceeds used to pay its creditors. Nevertheless, the concept [of best interests] is not without meaning in a municipal debt adjustment case. The concept should be interpreted to mean that the plan must be better than the alternative that creditors have.

²⁰⁰11 U.S.C. § 943 (“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.”); see *infra* text accompanying notes 230-235.

²⁰¹See C. Scott Pryor, *Third Time’s the Charm: The Coming Impact of the Restatement (Third) Restitution and Unjust Enrichment in Bankruptcy*, 40 PEPPERDINE L. REV. 843, 844-46 (2013) (explaining that equity in the common law tradition has a discrete and statable meaning).

²⁰²*Id.* at 851 (“[T]he principle of *pari passu* requires that all similarly situated creditors of a debtor be accorded equal treatment.”). See also Skeel, *supra* note 193, at 197 (identifying “comparable treatment for similarly situated creditors” as one of five core principles of any bankruptcy system).

²⁰³But see Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931 (2004) (arguing there should not be any bankruptcy-specific distributional provisions).

The dispute over whether a state's reserved Tenth Amendment rights are waived in favor of Congress' Article I powers was addressed in the case of Stockton's immediate predecessor in California municipal bankruptcy, the City of Vallejo. The plan of adjustment ultimately confirmed in Vallejo's case modified collectively bargained agreements with current employees, reduced benefits promised to retirees, cut accrued interest due on the city's bond debt, and reduced the rate of interest on those bonds going forward.²⁰⁴ In contrast with Stockton, Vallejo began its case by seeking to reject its current collective bargaining agreements. Vallejo's unions resisted the city's motion on a straightforward basis: California law prohibited it. As interpreted by California courts, the state's Meyers-Milias-Brown Act²⁰⁵ did not permit pre-expiration unilateral termination of public sector collective bargaining agreements.²⁰⁶ The bankruptcy court nonetheless found California law preempted by section 365 of the Bankruptcy Code²⁰⁷ and on appeal the district court affirmed the city's power to reject.²⁰⁸ Vallejo and its unions subsequently engaged in negotiations that culminated in new collective bargaining agreements that the city asserted would save it \$34 million over two years.²⁰⁹

Vallejo's retired employees, however, objected to any reduction in their benefits even if the decrease was part of a new collective bargaining agreement. The retirees' position was also grounded in well-established state law.²¹⁰ The court-appointed retirees' committee sued Vallejo in bankruptcy court for an injunction preventing any reduction in payments but the court concluded that the committee lacked standing and dismissed the action.²¹¹ The retirees then filed claims for unpaid benefits to which Vallejo objected. The bankruptcy court sustained the city's objections, holding that the retirees had no claims for benefit reductions so long as the retirees would be paid pursuant to the new collective bargaining agreements.²¹² In short, both employees and retirees found themselves subject to the powers afforded a debtor under bankruptcy law notwithstanding clear state law protections.

²⁰⁴See Vallejo's Second Amended Plan for the Adjustment of Debts at 26-31, 35-36, No. 08-26813 (Bankr. E.D. Cal. May 20, 2011), ECF No. 1044 (impairing the claims of its bondholders).

²⁰⁵CAL. GOV. CODE §§ 3500-11.

²⁰⁶See, e.g., *Glendale City Emps. Assn. v. City of Glendale*, 540 P.2d 609, 615 (1975) (describing collective bargaining agreements as "indubitably binding").

²⁰⁷*In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal. 2009).

²⁰⁸*Int'l Bhd. of Elec. Workers v. City of Vallejo (In re City of Vallejo)*, 432 B.R. 262 (E.D. Cal. 2010).

²⁰⁹See Disclosure Statement with Respect to Second Amended Plan for the Adjustment of Debts of City of Vallejo ("Vallejo Disclosure Statement") at 16, No. 08-26813 (Bankr. E.D. Cal. May 20, 2011), ECF No. 1045.

²¹⁰See *supra* text accompanying notes 34-37.

²¹¹Motion/Application for Order Appointing Unions as Retiree Benefit Representatives for Retirees from their Work Units, No. 08-26813 (Bankr. E.D. Cal. July 25, 2008), ECF No. 189.

²¹²No. 08-26813 (Bankr. E.D. Cal. Apr. 18, 2011), ECF Nos. 1078-1090.

With less litigation than with its employees and retirees, Vallejo and its bondholders agreed to reductions in interest and principal obligations.²¹³ The holder of the largest amount of Vallejo's securities agreed to reduce the present value of its claim by over 40%.²¹⁴ While precise comparison of the reductions of employees, retirees, and bondholders is difficult, it is clear all shared in the costs of Vallejo's financial distress. In other words, the plan did not discriminate unfairly; the principle of *pari passu* was honored.²¹⁵ Bankruptcy law priorities, not state law alternatives, filled in the content of bankruptcy fairness.

Financial implementation of bankruptcy fairness will typically assume the form of shared pain.²¹⁶ What is shared from an economic perspective is the realization of the risk of insolvency. Allocation of risk only to retirees and recipients of services is not fair.²¹⁷ Neither is shifting the entire burden to bondholders. Unfunded retiree benefits, even when protected by state law,²¹⁸ have no bankruptcy priority over the claims of bondholders.²¹⁹ Nor do bondholders over retirees. Regardless of state-law fairness, a court may dismiss the chapter 9 case if it concludes that a plan sought to be crammed down does not comport with bankruptcy fairness.²²⁰ An agenda of protecting those least able to diversify their risk is understandable. It is not, however, consistent with bankruptcy fairness.

Bankruptcy fairness can be ascribed to the results in *Vallejo* because all stakeholders realized some of the risk of insolvency. Thus, the result in *Central Falls* is unfair because one set of stakeholders bore none of the risk of insolvency, and can be justified only because all of the parties negotiated to a consensual plan. Certainly the state law that created the preferred status of bondholders casts a long and dark shadow over the negotiating process but the retirees impaired by Rhode Island's grant to bondholders could have re-

²¹³See Vallejo Disclosure Statement, *supra* note 209, at 37-46.

²¹⁴*Id.* at 38.

²¹⁵See Skeel, *supra* note 26, at 1070-71 ("Bankruptcy's 'equality of creditors' norm, which requires that similarly situated creditors receive generally similar treatment, would make it much more likely that other constituencies [bondholders] would share the burden."). While Skeel uses the term equality to describe this principle of bankruptcy, I prefer the term substantive fairness because it incorporates both vertical and horizontal fairness.

²¹⁶Bankruptcy fairness has been deemed to require a municipality to raise taxes only once. See *Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940) (applying chapter IX of the Bankruptcy Act). See also *In re Sullivan Cnty. Reg'l Refuse Disposal Dist.*, 165 B.R. 60 (Bankr. D.N.H. 1994).

²¹⁷See Skeel, *supra* note 96, at 702 ("Two constituencies in particular have been asked to bear a disproportionate percentage of the sacrifice during the recent crisis: the state's public employees and the recipients—especially the poor and lower middle class recipients—of its services.").

²¹⁸See *supra* text accompanying notes 34-37 (summarizing California law).

²¹⁹See Skeel, *supra* note 96, at 692 ("[I]n bankruptcy, pension beneficiaries' claims might well be protected only up to the amount of funds actually set aside for their payment. . . . [P]ension promises would be general unsecured claims in a bankruptcy . . .").

²²⁰See 11 U.S.C. § 901(a) (incorporating by reference § 1129(b)(1)).

fused to accept the plan. Whether the court in *Central Falls* would have crammed down the plan over the objection of retirees will never be known. The same uncertainty holds in any other case in which retirees enjoy a state-law priority that is not recognized in the Bankruptcy Code. Would the court cram down a plan implementing state law protection of vested pensions over the objection of the bondholders like Stockton's capital markets creditors? If so, cram-down would be an example of state law serving "as a mechanism for carrying out particular agendas under the cover of judicial robes."²²¹ Non-consensual reallocations of the effects of the risk of nonpayment inevitably will be seen as political but the bankruptcy question is whose politics will prevail?

C. WHOSE FAIRNESS? WHOSE JUSTICE?: STATE-LAW FAIRNESS THROUGH THE BACK DOOR

While the absolute priority rule and the principle of *pari passu* vindicate bankruptcy fairness, chapter 9 also requires that a plan be in the "best interests" of creditors. This requirement forces a comparison of a plan's proposed state of affairs to the "what if" of state law resolution. In other words, the best interests test aims to vindicate state-law fairness. The antecedents of section 943(b)(7)—the statutory source of the best interests test—are found in section 1129(a)(7). Briefly, this section provides that even if a creditor's class votes for a plan, an individual dissenter must be assured of receiving at least what would have been collected had the debtor been liquidated.²²² A creditor's best interests cannot be served if reorganization provides less than the worst case of chapter 7 liquidation.

Yet, comparison to liquidation under chapter 7 does not function in a chapter 9 bankruptcy because municipal debtors cannot be liquidated. It is thus no surprise that section 1129(a)(7) of the Bankruptcy Code is not incorporated into chapter 9. Instead, section 943(b)(7) simply mandates that to be confirmed a plan of adjustment must be in the best interests of creditors but without a baseline of comparison. Chapter 9's best interests test thus begs the question: By what standard are creditors' best interests to be measured?

The scope of best interests of creditors under chapter 9 is largely unmapped and the legislative history refers to only two cases.²²³ In the first, the Ninth Circuit had denied confirmation to an asset-rich irrigation district that refused to raise taxes to pay its unsecured creditors in full²²⁴ while in the other the Supreme Court reversed approval of a plan where the lower court simply had made no finding on the unused taxing power of a drainage dis-

²²¹Levitin, *supra* note 83, at 1450.

²²²11 U.S.C. § 1129(a)(7)(A)(ii).

²²³124 CONG. REC. 32,403 (Sept. 28, 1978) (remarks of Rep. Edwards).

²²⁴*Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940).

trict.²²⁵ Summarizing the import of this scanty data, Frederick Tung suggests that in chapter 9 the best interests test is satisfied when creditors receive “at least what they would have received by virtue of a mandamus proceeding under state law to compel an increased tax levy” to pay a municipality’s debt.²²⁶ A recent California bankruptcy decision applied the best interests test leniently, holding that a hospital district was not obliged to raise taxes to pay its creditors more than its plan provided.²²⁷ Indeed, contemporary courts generally give little weight to the best interests test because either, as in California, the ability to raise taxes is highly constrained²²⁸ or because the interests of a dissenting creditor were not representative of its class.²²⁹ A plan in a high-profile case that proposes to cram down creditors who have different state law priorities would force courts to examine the best interests test more critically.

Adam Levitin goes further and argues that the best interests standard trumps bankruptcy fairness, at least that aspect of bankruptcy fairness protected by the prohibition of unfair discrimination. Levitin suggests that the failure of chapter 9 to incorporate a federal priority scheme implies that state priorities should control bankruptcy fairness. In other words, the absence of a chapter 9 priority scheme must be filled with something and state law priorities are ready at hand. But chapter 9 does provide a priority scheme in both the vertical sense—fair and equitable—and the horizontal sense—unfair discrimination. Contrary to Levitin’s argument, the failure to incorporate the priority provisions of sections 725, 725, and 507 of the Bankruptcy Code means only that those statutory deviations from bankruptcy fairness do not apply in chapter 9. Indeed, equality is the baseline that silence does not displace. Bankruptcy fairness preempts state-law priorities yet the tension between the two standards of substantive fairness remains unresolved. After all, chapter 9 requires that a plan must be measured against both bankruptcy and state-law fairness to be confirmed—unless the creditors whose interests are in conflict consent.

D. ADJUSTMENT ACCORDING TO LAW

There is an additional statutory complication on the road to conformation

²²⁵Kelley v. Everglades Drainage Dist., 319 U.S. 415 (1943).

²²⁶Frederick Tung, *After Orange County: Reforming California Municipal Bankruptcy Law*, 53 *HASTINGS L.J.* 885, 899 n.69 (2002). See generally Jeff B. Fordham, *Methods of Enforcing Satisfaction of Obligations of Public Corporations*, 33 *COLUM. L. REV.* 28 (1933).

²²⁷*In re Corcoran Hosp. Dist.*, 233 B.R. 449, 459 (Bankr. E.D. Cal. 1999) (holding alternatively that raising tax assessments would be futile and that there was no requirement to do so).

²²⁸See *supra* text accompanying notes 24-25.

²²⁹See, e.g., *In re Connector 2000 Ass’n, Inc.*, 447 B.R. 752, 764, 770 (Bankr. D.S.C. 2011) (overruling single, late-filed objection to confirmation where all impaired classes had overwhelmingly accepted the plan).

of a chapter 9 plan. The bankruptcy fairness component of cram-down entails creditor equality. The best interests test resuscitates the question of state-law fairness. The application of section 943(b)(4) of the Bankruptcy Code is not clear. What does it mean for a court to confirm a plan only if a municipality “is not prohibited by law from taking any action necessary to carry out the plan”?²³⁰ Is “not prohibited by law” backward-looking? Does it prohibit a plan whose distributions would be inconsistent with state-law fairness? If so, bankruptcy fairness may be disregarded if state law so requires. Or is “not prohibited by law” forward-looking, referring only to what is done under the plan post-confirmation?

As with chapter 9’s best interests test, the “not prohibited by law” standard is underdeveloped. In the leading case, confirmation was denied where the plan would have paid impaired creditors by newly issued instruments that did not comply with state law. Thus, the bankruptcy court in Nebraska refused to confirm a plan in *Sanitary & Improvement Dist. # 7*²³¹ because it would create the possibility that bondholders under the plan could be paid less than warrant holders, which the court found to be contrary to Nebraska law: “Since state law requires full payment to bondholders, and since a plan cannot be confirmed if it permits a debtor to do something that is prohibited by state law, it cannot be confirmed.”²³² The holding did not, however, prohibit the impairment of the claims of prebankruptcy bondholders even though their payment was similarly mandated; Nebraska law had not changed while the case was pending. With respect to this concern, the court simply noted that there would be little utility to chapter 9 if any distribution inconsistent with state law rendered it non-confirmable.²³³ Section 943(b)(4) therefore meant that implementation of the plan must comply with state law; it did not mean that a plan cannot alter obligations enjoying state-law priority.²³⁴ Plans of arrangement have value because they bind dissenters but that power makes sense only if dissenters can be bound to something other than what state law already requires. The Bankruptcy Code’s mandate that a plan com-

²³⁰11 U.S.C. § 943(b)(4).

²³¹*In re Sanitary & Imp. Dist., # 7*, 98 B.R. 970 (Bankr. D. Neb. 1989).

²³²*Id.* at 974.

²³³*In re Cnty. of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996) (“Chapter 9 does not permit individual states to override the priority scheme that is inherent in the Code.”). See also *Sanitary Dist., # 7*, 98 B.R. at 974 (“If a municipality were required to pay prepetition bondholders the full amount of their claim with interest as contained on the face of the bonds and the SID had no ability to impair the bondholder claims over objection, the whole purpose and structure of Chapter 9 would be of little value.”).

²³⁴See *Sanitary Dist., # 7*, 98 B.R. at 974 (“The Bankruptcy Code permits modification of bondholder rights. The Bankruptcy Code permits an issuance of new bonds However, those ‘new bonds’ simply become a substitute for the original obligation and they must be issued in conformance with state law”).

ply with the law is thus unrelated to either bankruptcy fairness or state-law fairness.

A plan may be confirmed when creditors enjoying priority under state law will be impaired. Indeed, to grant such creditors priority in bankruptcy would be an example of unfair discrimination.²³⁵ Yet, a plan may not be confirmed that provides those creditors with less than they could recover outside bankruptcy; it is not in their best interests. And, perhaps regrettably, the “not prohibited by law” standard is not a tie breaker. This is the conundrum that creates the game of Chicken and drives stakeholders to compromise or face dismissal.

E. OUT OF BANKRUPTCY

Just as the bankruptcy court must evaluate a municipality's eligibility to be in chapter 9, it has the power to dismiss a case.²³⁶ Dismissal returns to the political process the distributional impact of the risk of a municipality's insolvency. Such a return may satisfy creditors like retirees in the short run but would certainly raise the cost of municipal finance in a state where such state-law priorities trumped bankruptcy fairness. Similarly, the bondholders of a city like Central Falls would have continued to enjoy the benefits of their newly acquired collateral had the court dismissed the case. But even there the political winners would have experienced subsequent costs. Having a lien or statutory priority is not the same as getting paid. Had the impaired retirees not voted to approve the plan of Central Falls, the bondholders would have needed to resort to legally uncharted waters to divert the city's general revenues to payment of its securities. Government officials have shown that they are adept at avoiding even judicial orders to raise taxes.²³⁷

If outside bankruptcy California cities like Stockton were to make the political choice to default on pension assessments, CalPERS could impose a punitive termination liability secured by a lien on all the assets of the city.²³⁸ Yet CalPERS cannot force a city to raise taxes or cut services; it can only force diversion of payments otherwise due to bondholders. The negative effects of grossly disproportionate treatment of retirees and bondholders on the ability of other California municipalities to use the bond market could be significant. Even creditors with strong state-law protections cannot be assured of payment outside bankruptcy. Municipal insolvency is generally a function of fiscal limitation rather than governmental gamesmanship.

²³⁵See *supra* text accompanying notes 219-221.

²³⁶11 U.S.C. § 930.

²³⁷See *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 510 (1942) (“[T]he right to enforce claims against the city through mandamus is the empty right to litigate.”).

²³⁸See *supra* text accompanying note 18.

Bankruptcy, especially municipal bankruptcy, is a political exercise.²³⁹ And the politics of chapter 9 are an amalgam of state law entitlements and bankruptcy fairness. A bankruptcy court need not insert itself in an intractable effort to resolve two sets of incommensurable values. Instead, the court should hold out the threat of dismissal that would leave the parties to their political and legal devices. Even if the contending parties cannot reach agreement, the effects of dismissal are not as permanent as what befell Buzz Gunderson.²⁴⁰

When confronted with the choice between a consensual plan and the vagaries of state law, one can expect a compromise. In other words, chapter 9 operates as a federally-sponsored forum for a game of Chicken.²⁴¹ Two cars racing toward each other are the prototypical format for the game of Chicken. The first driver to turn aside is a “chicken” or coward.²⁴² The winner who has driven straight ahead is confirmed in his vainglory. Of course, if neither turns aside both drivers die, albeit with a reputation for extraordinary toughness. In chapter 9, the sociopathy of two players of Chicken who would rather die than swerve are replaced by the rational calculators of bond insurers and representatives of retirees. Even though the judgment of sophisticated parties can be wrong, the possibility of a precedent-setting loss should be enough to cause at least one party to stop before the brink.²⁴³

Thus, extrapolating from game theory to bankruptcy law, the conflicting confirmation requirements of bankruptcy fairness and state-law fairness produce a system that no stakeholder prefers. All are effectively in the minority when faced with the real possibility that a court could confirm a plan that implements one standard at the expense of the other. The parties are further encouraged to settle because, unlike litigators who retain the cumulative gain of repeated games of Chicken, a single loss by either bondholders or retirees

²³⁹Levitin, *supra* note 83, at 1453.

²⁴⁰See *REBEL WITHOUT A CAUSE* (Warner Brothers 1955) (featuring classic “chickie run” scene resulting in plunge to the death of character Buzz Gunderson that features in much game theoretical analysis of game of Chicken).

²⁴¹See generally ANDREW M. COLMAN, *GAME THEORY AND ITS APPLICATIONS IN THE SOCIAL AND BIOLOGICAL SCIENCES* 111-15 (2nd ed. 1995) (analyzing game of Chicken).

²⁴²See David Crump, *Game Theory, Legislation, and the Multiple Meanings of Equality*, 38 HARV. J. ON LEGIS. 331, 368 (2001). See also Maxwell L. Stearns & Todd J. Zywicki, *PUBLIC CHOICE CONCEPTS AND APPLICATIONS IN LAW* 214-18 (2009) (describing basic game of Chicken with additional insights of “non-myopic” equilibrium alternatives).

²⁴³Indeed, rational calculations have prompted Stockton and its capital markets creditors to compromise. See First Amended Plan for the Adjustment of Debts of City of Stockton, *In re* City of Stockton, No. 12-32118 (November 15, 2013), ECF No. 1204. Stockton’s Plan does not impair the pension claims of its retirees but proposes to pay the capital markets creditors more than general unsecured creditors. Claims for Stockton’s rejection of its prepetition obligation to pay retiree health benefits are among the city’s general unsecured creditors.

would affect the legal landscape for many other cases. Bondholders legitimately fear that a court could recognize the state-law priorities for retirees, and retirees should be concerned that *pari passu* would equalize their recoveries with ordinary creditors. Pressing for total victory runs the risk of complete loss. Thus, as long as there is a consensual plan in which all parties share the risks of municipal insolvency that is less bad than the alternative—dismissal—the incommensurable rules of chapter 9 will have served a socially useful purpose.

V. CONCLUSION

Neither the ineliminable risk of nonpayment nor state law allocations of that risk should control confirmation of a plan of adjustment. For better or worse, Congress has made clear its policy choices by failing to subject issuance of municipal securities to substantial regulatory scrutiny, by granting blanket enforceability to pre-bankruptcy municipal liens and security interests, by requiring any plan to be in the best interests of creditors, and by providing a distributional ordering of *pari passu*. A bankruptcy court must evaluate whether a plan is in the best interests of creditors by comparing its projection to what would happen under state law, i.e., state-law fairness. Conversely, a bankruptcy court must also evaluate a plan's substantive fairness in terms of bankruptcy law, in particular, the prohibition of unfair discrimination. A bankruptcy court no less than Congress and state legislators—which together have created conflicting and perverse incentives—is subject to political bias. Leaving uncorrected what a judge may believe is an unfair initial allocation of risk is the best that can be done.²⁴⁴ Unless, of course, the parties can agree.

Bankruptcy fairness and creditor best interests have bite to the extent a plan fails to distribute payments according to bankruptcy law *and* the plan clearly leaves some creditors with less than would have been the case outside bankruptcy. Dismissal is the appropriate remedy when the stakeholders cannot agree on a plan that unfairly discriminates or fails the test of creditor best interests.

A court should not authorize actions taken while a case is pending that would create "facts on the ground" directing a plan's distributions free from a finding of bankruptcy fairness. A revitalized prohibition of creeping confirmation is in order where a municipal debtor proposes to assume a contract that creates unfair discrimination. The court should preserve as much flexibility as possible to drive the parties to an unhappy consensus. Chapter 9

²⁴⁴See Gillette, *supra* note 79, at 296 ("None of this denies that courts may suffer from their own biases in evaluating a municipality's financial position. Trying to determine the incentive structure of judicial decisions is a notoriously difficult task.")

should be deployed not simply as a rule but as an entire system that penalizes recalcitrance.

Substantive fairness is not a metaphysical standard. It need only be the worst state of affairs all parties can accept. So too, state law entitlements are simply the baselines from which the parties find their way to yes. The purpose of chapter 9 is not to reallocate the risk assigned by contract and state law. Chapter 9 exists to provide a forum in which the stakeholders can agree on how the effects of that risk can be borne. Substantive unfairness precedes bankruptcy and cram-down remains when the parties cannot agree on how far to bend chapter 9's distributional norms. Yet, even with cram-down the court must conclude that a plan comports with the principles of bankruptcy fairness and creditor best interests. The standard of fairness does not require absolute equality and the test of best interests does not require perfect consistency. Dismissal is the appropriate response if the discrepancies are too great. And dismissal—or its credible threat—will drive the parties—as they have driven Stockton and its capital markets creditors—to agree.