

Harvard Law School
Briefing Papers on Federal Budget Policy

Briefing Paper No. 47

**State and Municipal Pension
Liabilities:**

**Reform Inside and Outside of
Bankruptcy**

May 12, 2014

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INTRODUCTION

On July 18, 2013 the city of Detroit, Michigan filed for bankruptcy, the largest city in the history of the United States to do so. The problem was decades in the making and the causes primarily arose from an economic decline particularly focused on the auto industry, an eroding tax base, and financial commitments that it could no longer afford. Detroit in particular was hit harder than other cities as its population declined 63% since its postwar peak and had fallen 26% since 2000, leaving only 684,799 residents by December 2012.¹ The loss of manufacturing jobs that were the core of its automotive-based economy resulted in an 18.3% June 2012 unemployment rate, triple what it was in 2000.² Detroit's filing contained over \$18 billion in obligations including \$3.5 billion in unfunded pension liabilities.³

Yet the eroding tax base and existing obligations like the pension have made it nearly impossible for Detroit to maintain basic public services. Police response times in a city with the highest violent crime rate of any city with over 200,000 people is extremely slow compared to its peers and 40% of street lights in the city do not function.⁴ An emergency manager appointed by the Governor assessed the financial situation but ultimately a bankruptcy was filed to restructure the city's obligations. The public employee unions have opposed the bankruptcy plan filed on February 21, 2014, which proposes to cut pension benefits for city workers.⁵

Although some believe that Detroit's fate is unique, this case may be the first chapter of a broader public pension crisis as pension costs have become a growing liability for state and municipal governments struggling to balance budgets. Estimates of the total size of unfunded

¹ Exhibit A: City of Detroit Proposal for Creditors at 1, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. June 14, 2013).

² Id.

³ Id. at 23.

⁴ Id. at 9, 12.

⁵ Susan Tompor and Joe Guillen, *Detroit Pensioners Face Up to 34% Cut, Loss of Cost of Living in Orr Proposal*, Detroit Free Press, Feb. 21, 2014, <http://www.freep.com/article/20140221/NEWS01/302220009/detroit-plan-adjustment-pensions>.

public pension obligations vary between \$700 billion to \$3 trillion.⁶ Some methodologies even put the figure at \$4 trillion.⁷ Publicity has focused on this problem and investor Warren Buffett in his 2014 shareholder letter predicted that unaffordable pension promises will result in “bad news about public pension plans”.⁸ With this backdrop, it is important to understand the problem and assess potential solutions both inside and outside bankruptcy law.

Part I is an economic and accounting discussion, including the implications of new accounting standards. Part II will focus on legal constraints to public pension reform, especially examining the extent to which pension obligations are protected under state laws. Part III will then examine possible solutions under Federal bankruptcy law.

I: BACKGROUND ON ECONOMICS, ACCOUNTING, AND PUBLIC PENSION LAW

A) EXPLANATION OF DEFINED BENEFIT (DB) PENSION PLANS

DB pension plans create a particular challenge for states and municipalities by structurally committing them to promised benefits. A pension plan is a retirement benefit plan funded by contributions from the employer and/or employees and invested to cover expected future liabilities. Most public pension plans in the US are structured as DB plans. The IRS defines such plans as ones in which the participant receives a specified monthly payment at retirement based on factors including the participant’s salary, age, and years of service.⁹ Yet the key feature for understanding why governments believe them to be financial burdens is that the

⁶ Iris J. Lav and Elizabeth McNichol, *Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm*, Ctr. for Budget and Pol’y Priorities (Jan. 20, 2011), <http://www.cbpp.org/cms/?fa=view&id=3372>.

⁷ Joshua Rauh, *Shortfall for State and Local Pension Systems Today: Over \$4 Trillion*, Kellogg Insight Presents, Oct. 6, 2011, <http://kelloggfinance.wordpress.com/2011/10/06/shortfall-for-state-and-local-pension-systems-today-over-4-trillion/>.

⁸ Warren Buffett, *Berkshire Hathaway Inc. Shareholder Letter* (February 28, 2014), <http://www.berkshirehathaway.com/letters/2013ltr.pdf>.

⁹ *Definitions*, IRS.gov, <http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Definitions> (last visited Apr. 7, 2014).

risk is ultimately borne by the employer, known as the plan sponsor. If the investment returns are insufficient to cover benefits, the plan sponsor is still responsible for paying them.

This is in contrast to defined contribution (DC) plans such as 401(k) plans under which the employer and/or employee contribute to an individual account that maintains a value equaling the amount of contributions + investment gains/losses – administrative fees.¹⁰ The key difference is that the benefit amount depends on investment returns and the risk is borne by the individual participant rather than the plan sponsor. In general, corporations in the US have transitioned towards DC plans whereas public entities have been slower to adopt them and have continued to rely more on DB plans.

Lastly, Federal laws that otherwise would have forced states and municipalities to better fund their plans or provide insurance in case of failure simply do not exist. Corporate DB plans are governed under Federal law by the Employee Retirement Income Security Act (ERISA), which sets fiduciary responsibilities and minimum standards for participation, benefit accrual, and funding to ensure retirement safety.¹¹ Yet ERISA does not apply for public pension plans.¹² ERISA also created the Public Benefit Guaranty Corporation (PBGC), which administers insurance funds for pension plan benefits.¹³ Yet the PBGC also explicitly excludes public plans from its insurance plans.¹⁴

B) FUNDED STATUS AND INVESTMENT OF PLAN ASSETS

A plan's funded status is a commonly used metric because it compares the assets available to the accrued liabilities they must cover. The specific formula is as follows:

$$\textit{Funded Status} = \textit{Plan Assets} - \textit{Projected Benefit Obligation}$$

¹⁰ Id.

¹¹ Id.

¹² 29 U.S.C. § 1003(b) and §1002(32).

¹³ 29 U.S.C. § 1305.

¹⁴ 29 U.S.C. § 1321(b)(2).

A plan is considered underfunded if the value of assets is less than accrued liabilities for current and retired workers. Illinois is an important example to illustrate funded status since their five statewide public pension plans combined are generally considered the worst funded among the fifty states. For example, the Illinois State Employees' Retirement System (SERS) in June 2013 had a projected liability of \$34.7 billion but had an actuarial asset value of only \$11.9 billion, resulting in a funded status of only 34.2%.¹⁵ The projected benefit obligation (PBO) represents accumulated past benefits already earned by employees according to benefit terms in force at the measurement date (hereafter known as past accruals).¹⁶ However, it does include the effect of both automatic and projected ad hoc postemployment benefit changes such as cost of living adjustments (COLAs).¹⁷ The PBO excludes accruals for future service (hereafter known as future accruals) yet to be rendered by current employees, but will be earned according to terms at the initiation of their employment. PBO does not include benefits that have yet to accrue to future employees.

To better understand how a plan functions, it is also important to start with the asset side of the plan balance sheet. Investment returns are crucial for helping to fully fund a plan. Plan assets are typically invested across different asset classes. An example of a typical allocation the allocation used by the Illinois State Board of Investment, which manages assets for Illinois SERS as well as smaller amounts for the General Assembly Retirement System and the Judges' Retirement System of Illinois.

¹⁵ *2013 Annual Report*, Illinois State Employees' Retirement System, 55 (2013), available at <https://www.srs.illinois.gov/PDFILES/oldAnnuals/SERS2013.pdf>.

¹⁶ Governmental Accounting Standards Series, *Statement No. 68 of the Governmental Accounting Standards Board*, 10-11 (2012), available at <http://www.gasb.org/cs/BlobServer?blobkey=id&blobwhere=1175824328088&blobheader=application/pdf&blobcol=urldata&blobtable=MungoBlobs>.

¹⁷ *Id.*

Asset Class	Allocation (\$)	Allocation (%)	Target (%)
Domestic Equity	4,512,721,592.23	31.37%	30.00%
International Equity	2,925,248,587.30	20.33%	20.00%
Fixed Income & Cash	3,036,129,352.50	21.10%	20.00%
Private Equity	615,954,620.97	4.28%	5.00%
Real Estate	1,394,893,022.60	9.70%	10.00%
Real Assets	479,366,681.88	3.33%	5.00%
Hedge Funds	1,422,243,872.79	9.89%	10.00%
Total	14,386,557,730	100.00%	100.00%

Source: *Asset Allocation*, Illinois State Board of Investment (Feb. 28, 2014), http://www2.illinois.gov/isbi/Documents/Asset_Allocation.pdf.

Illinois' allocation is similar to many other public pensions as it is mostly invested in equities and alternative asset classes to earn returns that cover the costs of the liability.

C) CALCULATION OF LIABILITIES UNDER GOVERNMENTAL ACCOUNTING STANDARDS BOARD (GASB) CHANGES

Accounting methods for public pensions have become crucial to the public debate because benefit obligations are inherently estimates of future liabilities. Consequently, the use of varying methods and assumptions produces dramatically different financial results. These calculations are used to determine future pension benefits measured today at present value. There are three important elements defined by GASB:¹⁸

Step 1: Project future benefit payments for current and retired employees based on existing benefit terms and cost of living adjustments (COLA).

Step 2: Apply a discount rate to the sum of the future benefit payments in order to determine their present value.

¹⁸ *New GASB Pension Statements to Bring about Major Improvements in Financial Reporting*, Governmental Accounting Standards Board, 2 (2013), available at http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160140567.

Step 3: Allocate that present value over past, present, and future periods of employee service.

The following equation illustrates the role of the discount rate:

$$PV = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} + \dots$$

PV is the present value of the obligation, CF is the projected benefit payment, and r is the discount rate.

The central controversy focuses on step 2: determining the appropriate discount rate. Applying simple math, a smaller relative pension liability results from using a higher discount rate whereas a larger pension liability results from a lower discount rate. Governments and public employees have favored the use of discount rates between 7 and 8% and have argued that this is an appropriate rate given historical long-term investment returns that are used to cover the plan's costs.¹⁹ They favor the use of an investment return as the discount rate because in theory, if the plan assets grow by 7 to 8%, and the future value of the assets covers all future benefit payments, then the plan would be fully funded.

In contrast, many economists and actuaries have criticized the use of such a high rate as unrealistic since those returns were based on historically strong stock market returns in the 25 years preceding the stock market crash in 2008. Proposals for changing the rate include the use of a municipal bond borrowing rate. This arises from the idea that the discount rate should not be based on a high investment return rate but should also include the possibility that the state or municipality might have to borrow to fund benefit shortfalls. As a basis for comparison, corporations have to use yields on high rated corporate bonds with similar maturities to discount

¹⁹ Mary Williams Walsh, *Detroit Gap Reveals Industry Dispute on Pension Math*, N.Y. Times Dealbook, July 19, 2013, http://dealbook.nytimes.com/2013/07/19/detroit-gap-reveals-industry-dispute-on-pension-math/?_php=true&_type=blogs&_r=1.

their obligations – for instance Boeing uses a 3.8% discount rate.²⁰ Other proposals have called for the use of a risk free rate because in many cases the liabilities are guaranteed under state law.

GASB governs accounting rules for state and municipal governments and has recently made changes to discount rates in Statements 67 and 68. The GASB changes originated when studies began in 2006 to explore the possibility of changing the discount rate.²¹ Yet it took so long to implement that during the formulation process, the financial crisis likely contributed to the shift towards a blended rate. Beginning on June 15, 2013, the rate becomes a blended rate that uses the long-term expected return on investments up to the point at which plan returns and contributions exceed projected benefit obligations.²² Beyond that point, the rate will also use a high quality AA or higher, 20 year municipal bond rate.²³ With the new GASB rules coming into effect and fully implemented by 2015, the new discount rates will likely result in greater underfunding.²⁴ The new math means that this will result in higher future pension obligations since a blended discount rate will almost certainly be lower than 7-8%.²⁵

For instance, if GASB Statements 67 and 68 were in effect in 2010 then Illinois SERS would have used a blended discount rate of 6.2% resulting in a drop in funded status from 38.6% to 25.5%.²⁶ Across the fifty states, the implications of such a change would have been similar.

²⁰ Vipal Monga, *Why the Corporate Pension Gap Is Soaring*, Wall Street Journal, Feb. 26, 2013, <http://online.wsj.com/news/articles/SB10001424127887324338604578324831195349470>.

²¹ Mary Williams Walsh, *A New Plan for Valuing Pensions*, N.Y. Times, June 24, 2010, <http://www.nytimes.com/2010/06/25/business/25accounting.html>.

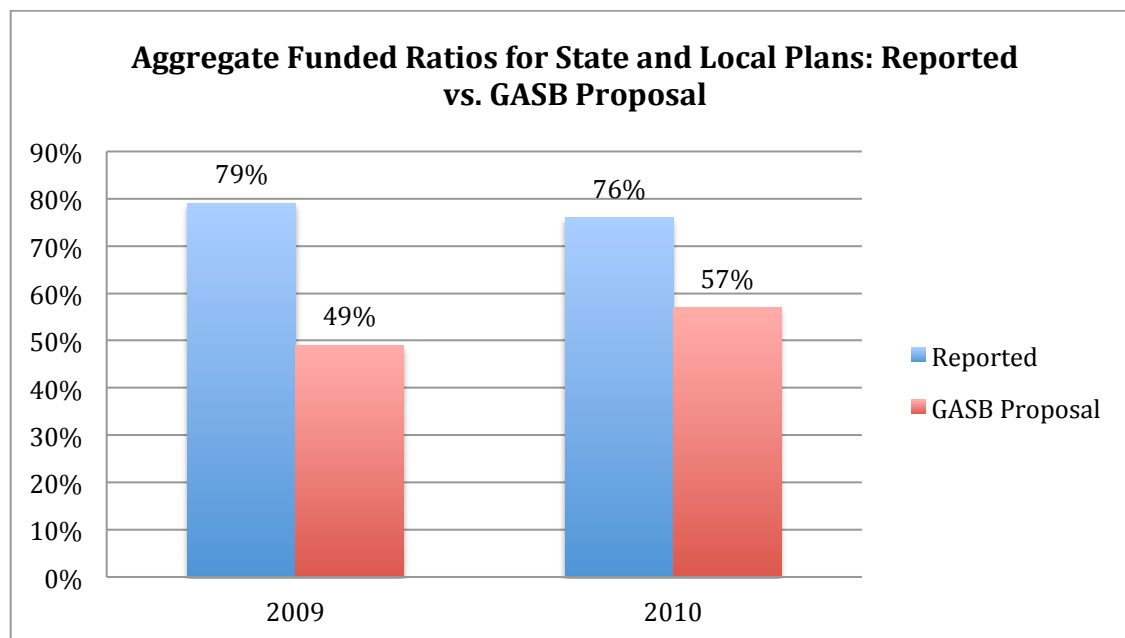
²² See *New GASB Pension Statements to Bring about Major Improvements in Financial Reporting*, Governmental Accounting Standards Board, 2 (2013), available at http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160140567.

²³ Id.

²⁴ Mary Williams Walsh, *New Rules on Public Pension Funds Seek Better Disclosure*, N.Y. Times, June 25, 2012, <http://www.nytimes.com/2012/06/25/business/new-rules-on-public-pension-funds-see-better-disclosure.html?pagewanted=all>.

²⁵ Alicia H. Munnell et al., *How Would GASB Proposals Affect State and Local Pension Reporting*, Ctr. for Ret. Research at Bos. Coll., Sept. 2012, http://crr.bc.edu/wp-content/uploads/2011/11/slp_23.pdf.

²⁶ Id.



Source: Alicia H. Munnell et al., *How Would GASB Proposals Affect State and Local Pension Reporting*, Ctr. for Ret. Research at Bos. Coll., Sept. 2012, http://crr.bc.edu/wp-content/uploads/2011/11/slp_23.pdf.

Furthermore, differences in discount rates can also lead to dramatic differences in the total size of unfunded liabilities across state and municipal plans across the US. Economist Joshua Rauh at the Kellogg School of Management at the Northwestern University has estimated that using an even more conservative Treasury discount rate the total size of unfunded liabilities would be \$4 trillion.²⁷ Broken down between states and municipalities, the states are a larger share of the total unfunded liability, at roughly \$3 trillion compared to \$574 billion for municipalities.²⁸ Although Rauh’s estimate for municipalities only contained the 77 largest municipal plans with assets over \$1 billion, it does cover 2/3 of the country’s municipal workers.²⁹

These unfunded pension benefits are a real obligation for the state and municipal governments. Yet this is still controversial not only because of the disagreement over the size but

²⁷ Joshua Rauh, *Shortfall for State and Local Pension Systems Today: Over \$4 Trillion*, Kellogg Insight Presents, Oct. 6, 2011, <http://kelloggfinance.wordpress.com/2011/10/06/shortfall-for-state-and-local-pension-systems-today-over-4-trillion/>.

²⁸ Robert Novy-Marx and Joshua Rauh, *The Crisis in Local Government Pensions in the United States*, at 48, in *Growing Old: Paying for Retirement and Institutional Money Management After the Financial Crisis* (Robert Litan and Richard Herring, eds., 2011).

²⁹ *Id.* at 48-49.

also the fact that they are not visible on their balance sheets. This is analogous to the similar controversy at the Federal level about whether unfunded entitlements should be recognized as a part of the national debt. In both instances, it can be argued that these are legal obligations that should be recognized in the same way as other types of borrowing.

D) PENSION EXPENSES AND ANNUAL BUDGETS

The total liability is not the only challenge facing state and municipalities. Periodic changes in costs need to be incorporated as expenses. For corporate pension plans, this is manifested in the annual cost as an item on the income statement. New GASB standards require expenses to be calculated by factoring benefits earned each year, interest on the total liability, changes in benefit terms, projected earnings on plan investments, and changes in plan position from other than investments.³⁰ This change is likely to result in higher annual costs as methods such as smoothing the recognition of investment losses over many years is eliminated.³¹ To cover this cost, funding comes from either the investment returns or contributions from the employer and/or its employees. For example, Illinois is expected to pay \$6.85 billion in contributions to cover its pension obligations.³² This will likely grow because Illinois has not yet fully implement the GASB changes and the specific discount rates will fall in the future. For instance, the Teachers' Retirement System still uses an 8% discount rate (lower than a previously used 8.5% rate), which will become a 6.94% rate after 2014.³³

³⁰ *New GASB Pension Statements to Bring about Major Improvements in Financial Reporting*, Governmental Accounting Standards Board, 3 (2013), http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160140567.

³¹ Mary Williams Walsh, *New Rules on Public Pension Funds Seek Better Disclosure*, N.Y. Times, June 25, 2012, <http://www.nytimes.com/2012/06/25/business/new-rules-on-public-pension-funds-seek-better-disclosure.html?pagewanted=all>

³² State of Illinois, Office of the Auditor General, *State Actuary's Report*, 11 (2013), available at <http://www.auditor.illinois.gov/Audit-Reports/Performance-Special-Multi/State-Actuary-Reports/2013-State-Actuary-Rpt.pdf>.

³³ *Id* at 48.

E) ECONOMIC CONSEQUENCES

Past benefit increases and low contributions have resulted in a growing financial challenge for state and municipal governments. In past years, it was usually easier for states and municipalities to give workers higher future pension benefits rather than current compensation increases given budget and political constraints. For instance, during the boom economy years, Illinois increased pension benefits.³⁴ California enacted large increases in benefits in 1999 when stock markets boomed during the dot com era.³⁵ More consequential was the lack of financial contributions from the state and municipal governments, which had the discretion to make contributions but often faced competing priorities such as the need to fund other programs or pressure to not raise taxes.³⁶

For example, Illinois' public pensions were underfunded historically, but their current situation can be traced to a 1994 plan that gradually increased state contributions over 50 years to achieve a 90% funded status by 2045, but backloaded most of the increased payments which increase sharply in the later years of the plan.³⁷ During the 2000s, \$10 billion in bonds were issued although only \$7.3 billion were used to fund the pension, and future contributions included debt service on those bonds, which effectively reduced the amount available to contribute to the pensions and in some cases were only half the amount required under actuarial calculations.³⁸ Such policies are not limited just to Illinois but were widespread across states and municipalities. For example, San Jose, California promised generous pension benefits that later

³⁴ Richard Ravitch and Paul A. Volcker, *Report of the State Budget Task Force: Illinois Report*, 21, (2012), <http://www.statebudgetcrisis.org/wpcms/wp-content/images/2012-10-12-Illinois-Report-Final-2.pdf>.

³⁵ Mary Williams Walsh, *Pension Ruling in Detroit Echoes West to California*, N.Y. Times Dec. 3, 2013, <http://www.nytimes.com/2013/12/04/us/pension-ruling-in-detroit-echoes-west-to-california.html>.

³⁶ Doug Finke, *State of Illinois' Record of Shorting Pensions Goes Back Decades*, Springfield State Journal-Register, Feb. 10, 2013, http://www.sj-r.com/x846054923/State-of-Illinois-record-of-shorting-pensions-goes-back-decades?zc_p=2

³⁷ Id.

³⁸ Richard Ravitch and Paul A. Volcker, *Report of the State Budget Task Force: Illinois Report*, 21, (2012), <http://www.statebudgetcrisis.org/wpcms/wp-content/images/2012-10-12-Illinois-Report-Final-2.pdf>.

grew to consume over half the city budget and resulted in cutbacks that reduced employee headcount and public services such as libraries, parks, and community centers.³⁹

Illinois is not immune from similar consequences. Although in 1995, only 4 cents out of every dollar in taxes were dedicated to public employee pensions, that share grew to 20 cents by 2013 and is on track to continue growing to reach 40% of state revenue by 2045.⁴⁰ The pension obligations have also contributed to Illinois receiving a credit rating of A- from Standard & Poor's, the lowest of any state.⁴¹ This has resulted in the highest borrowing cost among 17 states tracked by Bloomberg, at an interest rate spread over the 10 year municipal rate that is triple the spread paid by California.⁴² The consequences of this could have similar effects on reduced public services to cover pension costs in Illinois unless changes are made.

Although pension plans have shared in the upside of rising stock markets since 2010, the underfunding gap is now so large that even decades of double digit investment gains would be inadequate to fully fund most pension plans.⁴³ Yet plan sponsors have generally not made adequate contributions to those pensions to cover the cost of those promises. For example, California did not make additional contributions to their state retirement systems even after stock market crashes in 2000 and 2008 decreased the amount that investment returns could fund.⁴⁴ As a result, many states and municipalities will face negative consequences due to pension costs.

II: LEGAL CONSTRAINTS TO PUBLIC PENSION REFORM

³⁹ Michael Lewis, *California and Bust*, Vanity Fair, Nov. 2011, <http://www.vanityfair.com/business/features/2011/11/michael-lewis-201111>.

⁴⁰ Pew Research Center, *Illinois Needs to Pass Public Pension Reform*, July 2013, http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Illinois%20Needs%20Pension%20Reform.pdf.

⁴¹ Robin L. Prunty and John A. Sugden, *U.S. State Ratings and Outlooks: Current List*, Standard & Poor's, Feb. 1, 2013, http://www.standardandpoors.com/spf/upload/Ratings_US/US_StateRatings_OutlooksCurrentList_2_1_13.pdf.

⁴² Brian Chappatta, *Illinois Cuts Yields in \$1 Billion Sale as Penalty Drops 26%*, Bloomberg, Feb. 6, 2014, <http://www.bloomberg.com/news/2014-02-06/illinois-begins-1-billion-tax-free-bond-sale-after-pension-fix.html>.

⁴³ Tim Reid and Lisa Lambert, *U.S. Public Pensions Need More Than Investment Windfall*, Reuters, Mar. 10, 2014, <http://www.reuters.com/article/2014/03/10/us-usa-pensions-rally-analysis-idUSBREA2907320140310>.

⁴⁴ Id.

Given the fiscal pressures facing state and municipal governments, public officials are increasingly cognizant of this challenge. Since there is little political will to raise taxes to cover pensions, available options include increasing employer and/or employee contributions and/or benefit reductions to reduce projected benefit obligations. Yet there are numerous legal constraints that make it difficult to implement these options.

Historically, pension benefits were gratuities that legally did not vest and could be modified by the states. Indiana and the state administered public pensions in Texas are the only states that still function under such a legal regime. Several states explicitly protect pension benefits under their state constitutions. Most state courts have classified pension benefits as contracts, which are protected under the Contracts Clause of the US Constitution. The remaining states courts classify pension benefits as property, which are also protected as such under the US Constitution. Such regimes increase the difficulty of pension reforms that could be challenged as a violation of such legal protections. The following chart summarizes the state of the law:

Legal Basis	Accruals Protected			
	Past and Future	Past and Maybe Future	Past Only	None
State Constitution	AK, IL, NY	AZ	HI, LA, MI	
	AL, CA, GA, KS, MA, NE, NV, NH, ND, OR, PA, TN,	CO, ID, MD, MS, NJ, RI, SC	AR, DE, FL, IA, KY, MO, MT, NC, OK, SD, UT, VA	
Contract	VT, WA, WV			
Property	ME, WY	CT, NM, OH	WI	
Promissory Estoppel ¹	MN			
Gratuity				IN, TX ²

1 Promissory estoppel is the protection of a promise even where no contract has been explicitly stated.

2 This gratuity approach applies only to state-administered plans. Accruals in many locally-administered plans are protected under the Texas constitution.

Source: Alicia H. Munnell and Laura Quinby, *Legal Constraints on Changes in State and Local Pensions*, Ctr. for Ret. Research at Bos. Coll., Aug. 2012, http://crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf.

Interestingly, there is no clear relationship between the type of legal protection and funded status. Under each legal regime, there is a wide range between well-funded and poorly funded plans. For instance, states with constitution protection or contract protection are not obviously better or worse funded than Indiana and Texas, which treat them as gratuities.

State Constitution	Funded Status (%)
Alaska	59.2
Arizona	72.7
Hawaii	59.4
Illinois	43.4
Louisiana	56.2
Michigan	65.1
New York	92.7

Property	Funded Status (%)
Connecticut	55.0
Maine	80.2
New Mexico	67.0
Ohio	67.3
Wisconsin	99.9
Wyoming	85.9

Promissory Estoppel	Funded Status (%)
Minnesota	78.6

Gratuity	Funded Status (%)
Indiana	63.0
Texas	82.9

Contracts	Funded Status (%)	Contracts	Funded Status (%)
Alabama	66.9	Nevada	70.1
Arkansas	72.5	New Hampshire	57.4
California	77.4	New Jersey	67.8
Colorado	60.0	North Carolina	95.3
Delaware	90.7	North Dakota	68.8
Florida	86.9	Oklahoma	66.7
Georgia	82.5	Oregon	82.0
Idaho	89.9	Pennsylvania	67.8
Iowa	79.5	Rhode Island	59.2
Kansas	59.2	South Carolina	67.9
Kentucky	53.4	South Dakota	96.3
Maryland	63.9	Tennessee	91.5
Massachusetts	71.4	Utah	82.8
Mississippi	65.1	Virginia	69.5
Missouri	78.6	Vermont	70.4
Montana	66.3	Washington	69.5
Nebraska	81.9	West Virginia	64.2

Source: Standard & Poors, *A Bumpy Road Lies Ahead for U.S. Public Pension Plans*, 17-18 (2013), available at http://www.standardandpoors.com/spf/upload/Events_US/US_PF_Event_Webcast72913Article1.pdf.

A) STATE CONSTITUTION PROTECTION

Several state constitutions expressly prohibit reductions in public pension benefits although the strength and specific type of protection varies. The biggest distinction is whether protection includes only past accruals or if future accruals are also clearly protected. Again, past accruals refer to benefits already accrued by public employees, representing the accumulated amount that they have earned through their years of service. Future accruals are projections of promised benefits payable for projected future service.

Constitutions in Hawaii, Louisiana, and Michigan only expressly protect past accruals. Courts in Arizona have not settled whether the state constitution protections for past accruals also include future accruals. Alaska, Illinois, and New York expressly protect both past and future accruals. Illinois and New York have express provisions in their constitutions for such future accruals because the employee's benefits are fixed to the calculated benefit under terms that existed on the date of initial eligibility, and this benefit cannot be lowered.

1. Case Study: Illinois

The Illinois Constitution contains the following pension protection:

Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.

- Article XIII, Section 5

This provision has been interpreted to protect pension benefits as calculated on the date of eligibility when challenged in state courts. In *Kraus v. Board of Trustees*, a police officer contended that a new rule enacted by the town of Niles, Illinois that precluded him from earning

half his pre-disability salary violated the pension clause in the Illinois constitution.⁴⁵ The Illinois Appeals Court in 1979 agreed stating, “Section 5 of Article XIII prohibits legislative action that directly diminishes the benefits to be received by those who became members of the pension system prior to the enactment of the legislation”.⁴⁶

Illinois in particular which already has the most underfunded public pension system in the country, has attempted pension reforms that have been limited by this state constitutional protection. In December 2013, the Illinois General Assembly passed a bill to reduce pension costs by changing COLAs, which made several changes.⁴⁷ First, the COLA formula changed to 3% multiplied by the lesser of 1) the total annuity payable at the time of the increase or 2) \$1,000 multiplied by number of years of service and then increased each year by inflation.⁴⁸ Second, it increased the retirement age by up to 5 years depending on an employee’s age.⁴⁹ Additionally, it would cap the salary level used to calculate pension benefits, offer an optional 401(k) for workers willing to leave the existing system, and increase the state’s contribution to the pensions by \$60 to \$70 billion.⁵⁰ The expected cost savings were estimated to be \$90 to \$100 billion.⁵¹

The law passed with opposition from public employee unions and their supporters who argued that it unfairly punished workers who had paid into their pensions and had participated under the belief that the benefits would be available as promised. Legally, their arguments have focused on the contention that these changes are legally equivalent to a constitutionally

⁴⁵ Kraus v. Bd. of Trustees of Police Pension Fund of Niles, 390 N.E. 2d 1281, 1283 (Ill. App. Ct. 1979).

⁴⁶ Id. at 1293-1294.

⁴⁷ Rick Pearson, *Retired Teachers File First Lawsuit Against Illinois Pension Reform Law*, Chi. Tribune, Dec. 28, 2013, http://articles.chicagotribune.com/2013-12-28/news/chi-retired-teachers-file-first-lawsuit-against-illinois-pension-reform-law-20131227_1_employee-pension-system-illinois-pension-code-teacher-retirement-system.

⁴⁸ Ill. Pub. Act 098-0599.

⁴⁹ Id.

⁵⁰ Id.

⁵¹ Rick Lyman, *Illinois Legislature Approves Retiree Benefit Cuts in Troubled Pension System*, N.Y. Times, Dec. 3, 2013, http://www.nytimes.com/2013/12/04/us/politics/illinois-legislature-approves-benefit-cuts-in-troubled-pension-system.html?pagewanted=1&_r=0.

prohibited reduction in pension benefits. The public employee unions in Illinois have sued and have placed the pension clause in the constitution as the centerpiece of their argument for why these changes are illegal.⁵²

However, similar changes in COLAs in other states – Colorado and Minnesota – have been upheld. In Colorado, the plaintiffs were found to have no vested contract interests in a specific COLA amount for life and did not have reasonable expectations for it since it was changed numerous times in the past.⁵³ In Minnesota, the COLA was not found to be a core benefit and modification was necessary for the pension plan’s long-term sustainability.⁵⁴ The Illinois suit has now been consolidated with others filed by unions and the consequences will determine the room within which the Illinois state government has to reform public pension plans.

If the law is overturned, the alternative options available are to either seek a constitutional amendment, a voluntary plan change, or limit changes to new employees. However, these options are either difficult to achieve or have limited effects. A constitutional amendment must go through political procedures in order to be enacted. For instance, in Illinois, a constitutional amendment requires approval from both the state house and senate with a 3/5 majority and then must be approved by state voters in the next statewide election by either a majority voting in the election or 3/5 voting on the question.⁵⁵ A 2012 proposed constitutional

⁵² Complaint at 2-5, *Harrison et al. v. Quinn et al.*, No. 2014CH00040 (Ill. 7th Judicial Cir. Ct. Jan. 28, 2014).

⁵³ Alicia H. Munnell and Laura Quinby, *Legal Constraints on Changes in State and Local Pensions*, Ctr. for Ret. Research at Bos. Coll., Aug. 2012, http://crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf.

⁵⁴ *Id.*

⁵⁵ Ill. Const. art. XIV, §2.

amendment that would have required a 3/5 majority to increase pension benefits instead of just a simple majority, failed with Illinois voters.⁵⁶

A voluntary plan change is also difficult because it requires current pension plan participants to agree to a cut in benefits. In Illinois, given the strong opposition expressed in lawsuits opposing increases in the retirement age and COLA modifications, it appears unlikely that the public employees would be willing to voluntarily agree to benefit reductions. Lastly, any changes to benefits for new employees would have a very limited effect. Although it would help reduce future growth in pension benefits, it would not solve the problem because it does not make any changes to past or future accruals for current employees. The challenges that Illinois faces are already inclusive of projected benefit obligations for current workers and reductions for new workers would not affect them. Therefore, constitutional protection for pension benefits has left little legal room for significant changes.

B) CONTRACT PROTECTION

The majority of states courts provide legal protections for public pension benefits based on the US Constitution's Contracts Clause, which prohibits the impairment of contracts.

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

- Article I, Section 10

Similar to state constitutional protections, protection under contract can be divided between states that protect only past accruals, past and future accruals, and past and possibly future

⁵⁶ Joe Mahr, *Lawmakers Back to Square One After Pension Amendment Fails*, Chi. Tribune, Nov. 7, 2012, http://articles.chicagotribune.com/2012-11-07/news/ct-met--pension-referendum-follo-20121108_1_pension-system-amendment-public-unions.

accruals. A promissory estoppel approach used in Minnesota is similar although distinct from a contract approach and instead protects pension benefits on the basis of an implied contract, which exists to enforce a promise in order to prevent injustice.⁵⁷

Since treatment depends on a state-by-state basis, there is not an overall pattern except that they follow the Supreme Court's interpretation of the Contracts Clause which uses a three part test to determine whether a contract is impaired: 1) whether a contract exists, 2) whether state action impairs the contract, and 3) if state action does impair a contract then whether it is justified by a public purpose that is reasonable and necessary.⁵⁸

The first step is to determine whether a contract is formed. Without the existence of a contractual relationship prior to retirement, then states and municipalities would have more freedom to modify benefits. For example, the definition in Massachusetts as followed in many other states characterizes a contract as existing if the retirement scheme created an expectation by employees that they would be respected.⁵⁹ This is also a key part because courts can have different definitions as to what benefits are contractual. Some states only protect past accruals whereas others interpret the contract to include past and future accruals.

The second step is to determine if the contract is substantially impaired which depends on the legislative act enacted to change pension benefits. Again, the definition of impairment depends on the specific jurisdiction but generally is a legislative act that alters a relationship between the parties including those that deprives one of benefits under the contract or adds new

⁵⁷ Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework* 22 (Univ. of Minn. Law Sch. Legal Studies Research Paper Series), Research Paper No. 10-13, available at <http://lhc.ca.gov/studies/activestudies/pension/UniversityofMinnesota.pdf>.

⁵⁸ *Id.* at 12.

⁵⁹ *Id.* at 13 (citing Opinion of the Justices, 303 N.E.2d 320, 327 (Mass. 1973)).

duties or obligations or reduces the value of the contract.⁶⁰ Such impairments are substantial when there was reasonable reliance on that impaired right.⁶¹

The third step often addresses the issue of whether financial distress is a reasonable and necessary public purpose justification for state action that impairs a contract. The Supreme Court ruled that impairment could withstand constitutional protection of contracts if reasonable and necessary for an important public purpose.⁶² Such changes could be reasonable depending on whether the obligations had unforeseen or unintended effects when they were created and the degree of the impairment.⁶³ To establish that the act is necessary, the state must demonstrate that a less drastic modification would not accomplish the state's goal and the public policy goal could not be accomplished without the modification.⁶⁴

Yet meeting this standard in the courts has been difficult because it depends on the facts and circumstances of each case. For example, after a US Supreme Court decision prohibited states from giving tax-exempt retirement benefits only to state but not Federal employees, North Carolina responded by taxing state workers' benefits.⁶⁵ This was not found to be necessary because there were other ways in which the state could comply.⁶⁶ Similarly, the Nebraska Supreme Court found that Omaha's decision to eliminate a cost of living supplement benefit plan to be unnecessary despite the city facing a potential bankruptcy because the city did not include the elimination as part of their financial reports.⁶⁷ The court reasoned that since the elimination

⁶⁰ Id. at 14 (citing *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 240 (1978), *Northern Pac. Ry. Co. v. State of Minnesota*, 208 U.S. 583, 591 (1908), (see, e.g., *Retired Public Employees of Wash. v. Charles*, 148 Wash. 2d 602, 625 (2003)).

⁶¹ Id. at 16 (citing *Baltimore Teachers' Union v. Mayor and City Council of Baltimore*, 6 F.3d 1012, 1017 (4th Cir. 1993)).

⁶² Id. (citing *U.S. Trust Co. v. New Jersey*, 431 U.S. 1, 2, 25 (1977)).

⁶³ Id.

⁶⁴ Id. at 17-18 (citing *U.S. Trust Co. v. New Jersey*, 431 U.S. 1, 29-30 (1977)).

⁶⁵ Id. at 18-19 (citing *Bailey v. State*, 500 S.E.2d 54 (N.C. 1998)).

⁶⁶ Id. at 18-19 (citing *Bailey v. State*, 500 S.E.2d 54 (N.C. 1998)).

⁶⁷ Id. at 17 (citing *Calabro v. City of Omaha*, 531 N.W.2d 541 (Neb. 1995)).

was not in the original financial report, it was not the only way to avoid a bankruptcy and was therefore not necessary.⁶⁸

Reasonable and necessary is a difficult standard yet not impossible. It would depend on the specific facts and circumstances of a case, but it would be plausible to imagine a court allowing a contract impairment if the situation were dire. Perhaps this would probably depend on factors such as the degree of financial distress, the size of the pension and contributions relative to the overall budget, the extent to which contributions were made, the size of the proposed benefit cuts, and the extent to which there are other alternatives. However, even if this standard is legal there are additional practical difficulties. In essence, a state or city would have to first enact the cuts, wait to be sued by the public employee unions, and then wait for the courts to determine whether what they did was reasonable and necessary. This serves as a practical impediment because it calls for politicians to risk alienating the unions for an uncertain outcome.

On net, the consensus is that the benefits for the already retired cannot be impaired.⁶⁹ It is less clear whether this includes current employees except that states that find a contract to exist at the time of employment have less flexibility to make modifications than states that find the contract to exist when the employee is eligible for retirement.⁷⁰ For the former, a change that reduces benefits can only be justified as reasonable and necessary to achieve an important public purpose. Therefore, states and municipalities would likely resort to benefit reductions only after carefully considering all other alternatives given the murky status of the law.

1. Case Study: California

⁶⁸ See *Calabro v. City of Omaha*, 531 N.W.2d 541 (Neb. 1995).

⁶⁹ Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework* 21 (Univ. of Minn. Law Sch. Legal Studies Research Paper Series), Research Paper No. 10-13, available at <http://lhc.ca.gov/studies/activestudies/pension/UniversityofMinnesota.pdf>.

⁷⁰ *Id.*

California also protects pension benefits under a contract approach. In California, like in most states, although there is not an express constitutional protection for pension benefits, there is also a contracts clause that is similar to its counterpart in the US Constitution. For instance, in the California Constitution such protection is included in the following:

A... law impairing the obligation of contracts may not be passed.

- Article I, Section 9

California's case law also includes the three part test including the requirement that changes impairing pension benefits be reasonable and necessary to achieve a public purpose. Although courts allow some flexibility to adjust benefits, there are limits:

“Such modifications must be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees’ pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages”.

- *Betts v. Bd. of Admin.*, 21 Cal. 3d 859, 864 (1978)

Furthermore, *Betts* provides protection for both past and future accruals since it characterizes the pension as a vested contractual right to benefits that accrue upon acceptance of employment.⁷¹

This has made change especially challenging in municipalities facing increasing pension costs such as San Jose or those that filed for bankruptcy such as Vallejo and Stockton.

San Jose's annual pension costs rose from \$75 million in 2001 to \$245 million by 2011.⁷²

In response, 70% San Jose voters approved a ballot question that modified pension benefits by

⁷¹ *Betts v. Bd. of Admin.*, 21 Cal 3d 859, 863 (1978).

⁷² Jessica Calefati, *San Jose Mayor Pledges to Push Pension Reform Effort on 2016 Ballot*, San Jose Mercury News, Apr. 4, 2014, http://www.mercurynews.com/california/ci_25487881/san-jose-mayor-pledges-push-pension-reform-effort.

changing plan specifications for future workers as well as alterations to future accruals for current employees.⁷³ Although accrued past benefits were not effected, future benefits would either be subject to increased contributions by employees or accept new terms including a higher retirement age, a lower accrual rate, capping inflation indexing for COLAs, and basing benefits on the average final 3 year salary period.⁷⁴ This faced a court challenge by public employees and in 2013 the Santa Clara County Superior Court invalidated most provisions.⁷⁵ Specifically, provisions including the increase in contributions and COLA adjustments were a violation of vested rights.⁷⁶ However, the decision still allowed the city to cut employee salaries to offset pension costs, which if implemented would still save the projected \$68 million per year.⁷⁷

San Jose Mayor Chuck Reed also led an effort to amend the state constitution using a ballot initiative to allow mayors to renegotiate pensions to reduce future benefits, which is otherwise impermissible according to court interpretations. However, these attempts were also set back by legal challenges including the invalidation of the San Jose plan and political backlash that resulted in its exclusion from the 2014 statewide election ballot.⁷⁸

2. Case Study: Rhode Island

In some cases, states can successfully modify benefits even if the law protects them as contracts, although legal and political obstacles often remain. In 2011, the Rhode Island General Assembly enacted the Rhode Island Retirement Security Act that raised the retirement age for

⁷³ *Pension Ballot Initiative Fact Sheet*, Office of Mayor Chuck Reed (June 8, 2012), available at <http://www.sanjoseca.gov/DocumentCenter/View/3963>.

⁷⁴ *Id.*

⁷⁵ *San Jose Police Officers' Assn. v. City of San Jose, et al.*, No. 1-12-CV-225296 (Santa Clara Cnty. Super. Ct. Dec. 19, 2013).

⁷⁶ *Id.*

⁷⁷ Mike Rosenberg, *Pensions for City Workers Can't Be Cut, But Pay Can, Judge Rules in Major San Jose Case*, San Jose Mercury News, Dec. 23, 2013, http://www.mercurynews.com/pensions/ci_24782960/pensions-city-workers-cant-be-cut-but-pay.

⁷⁸ Jessica Calefati, *San Jose Mayor Pledges to Push Pension Reform Effort on 2016 Ballot*, San Jose Mercury News, Apr. 4, 2014, http://www.mercurynews.com/california/ci_25487881/san-jose-mayor-pledges-push-pension-reform-effort.

existing public employees, suspended COLAs until the pension was 80% funded, and shifted workers from a DB plan towards a hybrid DB/DC plan.⁷⁹ The public employee unions sued arguing that these changes were a violation of contract protection for their benefits and used similar arguments applied in other jurisdictions.

A proposed settlement would have kept most of these changes.⁸⁰ Yet even this proposed settlement demonstrates the practical difficulty of enacting changes. Even though state employees and teachers agreed to the changes in the proposed settlement, the police union rejected it by a 61% majority.⁸¹ Since a rejection by any one of the plaintiffs groups is enough to end the settlement process, the parties are now back to mediation as a trial date of September 15, 2014 has been set.⁸² Rhode Island was another state that clearly protected past accruals but the status of future accruals was uncertain. Therefore, the extent of protection under contract does depend and vary on how state courts interpret its strength and apply contract law. However, the consistent theme is that it does impose legal limitations for states and municipalities attempting to reduce or modify their pensions.

C) PROPERTY PROTECTION

Other jurisdictions protect pension benefits under the legal theory of property protection. The US Constitution prevents the taking of property without due process under the 5th and 14th Amendments and just compensation under the 5th Amendment.⁸³ Currently, Wisconsin protects

⁷⁹ Rick Lyman, *Rhode Island Reaches Deal to Soften Pension Changes*, N.Y. Times, Feb. 14, 2014, <http://www.nytimes.com/2014/02/15/us/rhode-island-reaches-deal-to-soften-pension-changes.html>.

⁸⁰ Id.

⁸¹ Katherine Gregg, *Police Reject R.I. Pension Settlement, Sending Parties Back to Mediation*, Providence Journal, Apr. 7, 2014, <http://www.providencejournal.com/politics/content/20140407-police-reject-r.i.-pension-settlement-sending-parties-back-into-mediation.ece>.

⁸² Id.

⁸³ Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework* 24 (Univ. of Minn. Law School Legal Studies Research Paper Series, Research Paper No. 10-13, available at <http://lhc.ca.gov/studies/activestudies/pension/UniversityofMinnesota.pdf>).

only past accruals, whereas Maine and Wyoming protect past and future accruals, and Connecticut, New Mexico, and Ohio protect past accruals and may protect future accruals.

Legally, the protection of such benefits as property includes several steps including first the need to establish benefits as property and then second demonstrating that changes to pension benefits fail to accord with due process and just compensation.⁸⁴ Property interests have extended beyond just the traditional definition of property and are recognized to also include benefits if there is a legitimate claim of entitlement to them, beyond just a need, desire, or unilateral expectation of receiving it.⁸⁵ For example, Connecticut protects pension benefits as a property interest because the state laws create a legitimate entitlement claim because the benefits vest.⁸⁶

However, property interest arguments typically falter when attempting to argue that there is a violation of due process. For due process, most challenges are made on substantive due process grounds which requires a demonstration that there is a deprivation of a fundamental right protected by the Constitution that is “arbitrary and outrageous” state conduct that “shocks the conscience”.⁸⁷ Yet it must be demonstrated that the changes to pension benefits are not rationally related to a legitimate state interest.⁸⁸ This is typically an easy standard to satisfy because actions intended to deal with financial crises or correcting for disparate retirement ages based on gender have been found to be legitimate state interests.⁸⁹ In the latter instance, changes in benefits for workers more than five years away from retirement was permissible.⁹⁰

⁸⁴ Id.

⁸⁵ Id. at 25 (citing *Bd. of Regents v. Roth*, 408 U.S. 564, 577 (1972)).

⁸⁶ Id. (citing *Pineman v. Oechslein*, 488 A.2d 803 (Conn. 1985)).

⁸⁷ Id. at 26 (citing *Walker v. City of Waterbury*, 601 F. Supp.2d 420, 424 (D. Conn. 2009)).

⁸⁸ Id. (citing *Parker v. Wakelin*, 937 F.Supp. 46, 58 (D.Me. 1996)).

⁸⁹ Id. (citing *Walker v. City of Waterbury*, 601 F. Supp.2d 420, 435 (D. Conn. 2009) and *Pineman v. Fallon*, 842 F.2d 598 (2nd Cir. 1988)).

⁹⁰ Id.

Lastly, lawsuits based on the takings clause have not been successful in protecting pension benefits as property. Courts have found that participants do not have the required investment-backed expectations in the absence of a contract and therefore adjustments to pensions are merely “an adjustment to the benefits and burdens of economic life”.⁹¹ Therefore, the property interest theory appears to provide relatively weaker protections in the states that utilize it.

III: POSSIBLE SOLUTIONS IN BANKRUPTCY

Federal bankruptcy law addresses municipal bankruptcies but the status of pension benefits has become a litigated legal issue without clear law guiding its use. The Detroit bankruptcy has focused this front and center and it will likely take a US Supreme Court decision to determine whether or not pension benefits can be cut under the Federal laws governing municipal bankruptcies.

A) BACKGROUND ON CHAPTER 9 FEDERAL BANKRUPTCY

Background on Chapter 9 is important because without it, municipal governments would be limited in their legal options given the existing protections for pension benefits. Federal bankruptcy law is traditionally applied to corporate reorganizations but Chapter 9 of the US bankruptcy code is specifically applied to municipal bankruptcies. The code defines a municipality as a “political subdivision or public agency or instrumentality of a state”.⁹² This definition is not limited to just the municipal governments themselves but also includes entities such as power and water districts.⁹³ It is important to note however that this definition does not include states, which cannot declare bankruptcy under Chapter 9 or any other part of the code.

⁹¹ Id. at 27 (citing *Pineman v. Fallon*, 842 F.2d 598 (2nd Cir. 1988)).

⁹² 11 U.S.C. §101(40).

⁹³ Douglas G. Baird, *Elements of Bankruptcy*, 16, 5th Ed., 2010.

Eligibility has been a contentious issue and as demonstrated in the Detroit bankruptcy, multiple factors must be satisfied. Under §109, the entity must satisfy all of the following factors: 1) the entity is a municipality, 2) it has specific authorization by state law or state agency to file for bankruptcy, 3) it is insolvent, 4) it must desire to effect a plan, and 5) it must satisfy 1 or 4 conditions including either consent from a majority of creditors in the amount for each class that will be impaired, it failed to obtain such consent only after a good faith negotiation, it was unable to negotiate with creditors because it was impracticable, or it believes the creditor may attempt to obtain an avoidable transfer of funds.⁹⁴

B) CONSTITUTIONAL ISSUES: FEDERAL PREEMPTION OF STATE LAW

The major question that remains unresolved is whether it is constitutional for a Chapter 9 municipal bankruptcy to reduce or impair pension benefits. Public employee unions have argued that Chapter 9 itself is impermissible under the 10th Amendment because it may impair pension benefits. The Detroit bankruptcy case included a ruling on whether the Chapter 9 bankruptcy process can legally reduce pension benefits. This is fundamentally a question of whether Federal bankruptcy law can preempt state laws protecting pension benefits.

The Constitution contains the Bankruptcy Clause in Article I, Section 8, which states that Congress has the power to establish uniform laws governing bankruptcy. Furthermore, the Supremacy Clause or Article VI, Clause 2 establishes Federal law as the highest law that preempts state law if there is a conflict and the relevant Federal law is constitutionally authorized. However, the 10th Amendment reserves powers to the states if not delegated to the Federal government under the Constitution or prohibited by it to the states. The Federalism question is important for the pension because the Detroit bankruptcy filing did not explicitly

⁹⁴ 11 U.S.C. §109.

protect pension benefits and therefore it presumably may be impaired in the Chapter 9 bankruptcy process.

This is not the first time Federal municipal bankruptcy law was challenged for preempting state law. Chapter 9's existence was litigated decades before in *US v. Bekins*, which upheld the Municipal Bankruptcy Act of 1937. Prior to this decision, attempts to include municipalities in Federal bankruptcy law ran into legal challenges to the preemption of state law such as in *Ashton v. Cameron County District* in 1936. *Ashton* dealt specifically with Federalism and the Supreme Court held that the original Federal statute governing municipal bankruptcies was invalid because it restricted a state's ability to control its own financial affairs, even though the states did agree to let municipalities access the Federal statute.⁹⁵ *Bekins* dealt with the Congressional response to *Ashburn* and attempted to clearly establish that the Federal government was still respecting state sovereignty. Crucially, *Bekins* reversed *Ashton* and characterized the relationship between states and the Federal government as cooperation through invitation by the state and its inclusion in Federal bankruptcy law was necessary as a tool for municipalities.⁹⁶ The characterization of cooperation is important both for validating Chapter 9 but also the Detroit case as well.

Opposition to the Detroit bankruptcy filing as a violation of the 10th Amendment focused on the potential conflict between the use of bankruptcy law to reorganize pension benefits and the state law in Michigan whose state constitution protects accrued pension benefits. Michigan's Constitution includes the following language:

No . . . law impairing the obligation of contract shall be enacted.

- Article I, Section 10

⁹⁵ See *Ashton v. Cameron County District*, 298 U.S. 513, 531 (1936).

⁹⁶ See *United States v. Bekins*, 304 U.S. 27, 51-53 (1938).

The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.

- Article IX, Section 24

This language sets up the central controversy over whether the filing of a municipal bankruptcy under Federal law. Judge Steven Rhodes addressed these pension issues in a broader Federal bankruptcy court decision in December 2013 that allowed Detroit to be eligible for a Chapter 9 filing. This decision is only binding in the Eastern District of Michigan, but given the lack of precedent, Judge Rhodes' reasoning was closely studied as other courts may invoke similar reasoning in the future.

The opposition argues that this is a violation of Federalism because it allows Congress to set rules controlling fiscal self management which is actually an area of state sovereignty. They further argue that by a Chapter 9 filing threatens pension obligations because the process inherently restructures debts and obligations. Yet this appears to conflict with state laws in Michigan including the state's constitutional protection of pension benefits. Although Federal law does preempt state law through the Supremacy Clause, the argument is that such preemption is a violation of Federalism.

Judge Rhodes however ruled Chapter 9 does not violate the 10th Amendment.⁹⁷ First, he affirmed that *Bekins* has already established the constitutionality of Chapter 9 bankruptcy.⁹⁸ Furthermore, subsequent jurisprudence on the 10th Amendment in *New York v. United States* and *Printz v. United States* does not undermine the validity of *Bekins*, which is therefore still

⁹⁷ In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. Dec. 5, 2013).

⁹⁸ Id. at 49.

constitutional.⁹⁹ Both cases also acknowledge that the 10th Amendment is not violated if states consent to enter a voluntary relationship with the Federal government.¹⁰⁰

Applied to Detroit, the state of Michigan did consent when Governor Snyder exercised his statutory right to put local governments into Chapter 9.¹⁰¹ *Bekins* still applies because the Chapter 9 bankruptcy filing was voluntary and the Federal government did not compel the state to authorize the filing. Following this logic, the opinion states that the 10th Amendment does not prohibit the impairment of a contract right otherwise protected by the state constitution since the state consented to a Chapter 9 bankruptcy filing.¹⁰²

There is however, an argument that Detroit did not truly consent even if the Governor of Michigan did. However, the Governor was authorized under Public Act 436 to do so and the Federalism objection relates to the state of Michigan's sovereignty, not Detroit's. Additionally, Judge Rhodes upheld the constitutionality of Public Act 436 under Michigan state law based on how the Michigan Supreme Court previously ruled on cases related to the right to referendum, home rule, and the pensions clause.¹⁰³ There is an argument that fundamentally, this is a political matter since it accords with a law passed by the state legislature. It would follow similar arguments made in *Bennett v. Napolitano* in Arizona, in which it was reasoned that the proper forum for resolving this dispute is in the legislature and not the courts.¹⁰⁴

⁹⁹ See *Id.* at 65-70. (*New York v. United States* dealt with a 10th Amendment objection to a Federal law which provided incentives for states to take responsibility for managing radioactive waste in their state. The portions upheld as constitutional gave states a choice of whether to participate or not but held that a portion that in practice forced states to regulate waste according to Federal standards was unconstitutional because there was no consent. *Printz v. United States* held that provisions of the Brady Handgun Violence Prevention Act, which required background checks for firearms dealers and that the checks comply with Federal law, were unconstitutional because they were mandatory and lacked state consent).

¹⁰⁰ See *Id.* at 69.

¹⁰¹ See *Id.* at 36, 73.

¹⁰² *Id.* at 80.

¹⁰³ *Id.* at 83-84.

¹⁰⁴ See Richard Briffault, *Courts, Constitutions, and Public Finance: Some Recent Experiences from the States*, in *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy* (Elizabeth Garrett, Elizabeth A. Graddy & Howell E. Jackson eds., 2008).

A separate argument casts pension obligations as distinct from other forms of municipal debt since there is a separate pension protection clause in the state constitution. However, Judge Rhodes decided that pension obligations are not distinct from other forms of municipal debt and furthermore, the pension protection are protected as contract rights, which may in fact be impaired if there is voluntary consent.¹⁰⁵ Judge Rhodes was careful in explaining that just because pension rights can be impaired in a Chapter 9 bankruptcy it does not mean that courts will necessarily confirm a reorganization plan that impairs pension benefits.¹⁰⁶ The effect is that like in corporate reorganizations, funded pension benefits will be secured but the unfunded liability will be treated as unsecured credit.¹⁰⁷

Yet opponents of the filing including public employee unions have appealed and continue to argue that this bankruptcy is impermissible. Therefore this question of Federalism is unresolved. The American Federation of State, County, and Municipal Employees (AFSCME) and two union pension funds have appealed to the 6th Circuit. If no there is no settlement, the US Supreme Court may settle the issue and if so the timing of the decision would likely take place in 2015 or 2016. If not, whatever decision the appeals court reaches would only be binding within the 6th Circuit and would not be precedential in other courts. Even if it is upheld all the way to the Supreme Court, if the jurisprudence allowing benefit reductions relies on state consent, it still may be limited. Only 15 states specifically authorize municipal bankruptcies, 9 states including Michigan conditionally authorize it, and 3 states have limited authorizations.¹⁰⁸

¹⁰⁵ Id.

¹⁰⁶ Id.

¹⁰⁷ Mary Williams Walsh, *In Detroit Ruling, Threats to Promises and Assumptions*, N.Y. Times, Dec. 4, 2013, <http://www.nytimes.com/2013/12/05/us/in-detroit-ruling-threats-to-promises-and-assumptions.html?pagewanted=1>.

¹⁰⁸ James E. Spiotto, *Unfunded Pension Obligations: Is Chapter 9 the Ultimate Remedy? Is There a Better Resolution Mechanism*, Chapman & Cutler, 48 (June 2011), available at <http://www.sec.gov/spotlight/municipalsecurities/statements072911/spiotto-slides2.pdf>.

States Specifically Authorizing Municipal Bankruptcies		States Conditionally Authorizing Municipal Bankruptcies	
AL	Code 1975 § 11-81-3	CT	Gen. Stat. Ann. § 7-566
AZ	Rev. Stat. Ann. § 35-603	FL	Stat. Ann. § 218.01
AR	Code Ann. § 14-74-103	LA	Rev. Stat. Ann. § 39-619
CA	Gov't Code § 53760	MI	Comp. Laws § 141.1222
ID	Code Ann. § 67-3903	NJ	Stat. Ann. § 52:27-40
KY	Rev. Stat Ann. § 66.400	NC	Gen. Stat. Ann. § 23-48
MN	Stat. Ann. § 471.831	OH	Rev. Code Ann. § 133.36
MO	Ann. Stat. § 427.100	PA	Cons. Stat. Ann. § 11701.261
MT	Code Ann. § 7-7-132	RI	Gen. Laws §45-9-7
NE	Rev. St. § 13-402	States with Limited Authorization	
NY	Local Finance Law § 85.80	CO	Chapter 9. Section 32-1-1403
OK	Stat. Ann. tit. 62 §§ 281, 283	OR	Rev. Stat. §548.705
SC	Code Ann. § 6-1-10	IL	Comp. Stat. Ann. 3855/1-20(b)(15)
TX	Loc. Gov't Code § 140.001	States Prohibiting Filing	
WA	Rev. Code § 39.64.040	IA	Code Ann. § 76.16
		GA	Code Ann. § 36-80-5

Source: James E. Spiotto, *Unfunded Pension Obligations: Is Chapter 9 the Ultimate Remedy? Is There a Better Resolution Mechanism*, Chapman & Cutler, 48 (June 2011), available at <http://www.sec.gov/spotlight/municipalsecurities/statements072911/spiotto-slides2.pdf>.

This case is being closely watched by other municipalities across the country because it will have large implications as it will determine the amount of space they would have if there are similar state laws protecting pension benefits. For instance, the practical effect may be that in some cities currently in bankruptcy such as San Bernardino, California, the Detroit decision affects the negotiation process now that a Federal bankruptcy judge has allowed pension impairments even if the decision does not bind California courts.¹⁰⁹

C) ADDITIONAL CONSTITUTIONAL ISSUES

An additional argument that raises constitutional issues is that allowing a Chapter 9 bankruptcy filing violates the Contracts Clause in Article I, Section 10 of the US Constitution.

¹⁰⁹ Mary Williams Walsh, *Pension Ruling in Detroit Echoes West to California*, N.Y. Times Dec. 3, 2013, <http://www.nytimes.com/2013/12/04/us/pension-ruling-in-detroit-echoes-west-to-california.html>.

Since most states protect pension benefits under contract law or as contracts protected by the state constitutions, changing pension benefits would be an unconstitutional violation of the Contracts Clause. This argument was litigated in the Detroit case but Judge Rhodes quickly and briefly dismissed this claim as frivolous since the bankruptcy code authorizes Congress to make laws impairing contracts.¹¹⁰ Professor David Skeel at the University of Pennsylvania Law School argues that the Supreme Court would likely uphold Chapter 9 in spite of the Contracts Clause challenge because *Bekins* has been settled as constitutional since 1938.¹¹¹ Additionally, the Contracts Clause likely would not stop a restructuring if it is a better option for creditors than any alternatives, and since the Constitution supports the use of bankruptcy in the bankruptcy clause in Article I.¹¹²

A third argument on constitutional grounds is that the Chapter 9 filing is a violation of the takings clause in the 5th Amendment of the US Constitution. This was not litigated in the Detroit cause simply because the state of Michigan protected pension benefits under a contract law theory. Yet similar to how some states protect pension benefits under a state property law regime, it similarly is weak protection for the unfunded portion of pensions. Like with the states, this is based on the fact that the US Supreme Court has focused on the claimant's investment backed expectations to determine what is property and the unfunded benefits will likely not receive the same treatment as the funded portion.¹¹³

D) NEGOTIATION IN THE SHADOW OF BANKRUPTCY

Ultimately, both the city and the public employee unions are conducting a negotiation. The law, particularly bankruptcy law, frames the range of possible outcomes for both parties.

¹¹⁰ In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. Dec. 5, 2013).

¹¹¹ David A. Skeel, *Can Pensions Be Restructured in (Detroit's) Municipal Bankruptcy?*, at 14 (Univ. of Pa. Law Sch. Inst. for Law and Econ.), Research Paper No. 13-33, available at SSRN: <http://ssrn.com/abstract=2360302>.

¹¹² Id. at 14-15.

¹¹³ Id. at 13-14.

Therefore, the initial court decision has a huge influence in setting up the bargaining process between the city and the unions. Until Judge Rhodes' decision, it was not clear that bankruptcy would be an option to reduce benefits. Although the case is being appealed, the decision created more certainty because a Federal judge permitted it. As a result, negotiations have progressed between the unions and the city as they seek to an agreement rather than continue litigating.

Judge Rhodes, who is overseeing the bankruptcy, set a date of June 16 –27 for the confirmation hearing to determine if Detroit's proposed restructuring plan is "fair and equitable" under bankruptcy law.¹¹⁴ The public employee pensions fear that the bankruptcy plan could be approved faster than they have to argue for an appeal but the 6th Circuit has so far denied their request to fast track the appeal.¹¹⁵ In the meantime, the City of Detroit filed a plan of adjustment with the US Bankruptcy Court on February 21, 2014. The plan proposed would reduce benefits for the police and fire pension by 6% and the general pension by 26% if they agree to the plan.¹¹⁶ Otherwise, the proposal would reduce benefits by 10% for the police and fire pension and 32% for the general pension if they challenge it.¹¹⁷

With the eligibility decision and Detroit's concrete proposals on the table, this has prompted the city and unions to become more willing to reach a settlement rather than face the uncertainty of a continued legal battle. For the unions, one possibility is that any final settlement that at least exceed the amounts in the original bankruptcy plan would be seen as a victory and would be easier for their leadership to sell to the rank and file. Compared to the alternative, a

¹¹⁴ Nathan Bomey, *Big Battles Loom As Judge Sets Fast Pace in Detroit Bankruptcy*, Detroit Free Press, Feb. 24, 2014, <http://www.freep.com/article/20140224/NEWS01/302240075/Chapter-9-Detroit-bankruptcy-Steven-Rhodes-disclosure-statement>.

¹¹⁵ Brent Snively, *Pension Funds Ask for Fast-Track Course for Detroit Bankruptcy Appeal*, Detroit Free Press, Mar. 18, 2014, <http://www.freep.com/article/20140318/NEWS01/303180136/Retirement-systems-court-of-appeals-bankruptcy>.

¹¹⁶ Id.

¹¹⁷ Id.

negotiated settlement might actually serve their interests better now that the bankruptcy has changed their expectations.

Progress is being made since on April 16, 2014, negotiators for the pensions agreed to retiree benefit cuts that were even less painful than those proposed in the city's original reorganization plan.¹¹⁸ This is partly as a result of strong recent investment returns for the pensions that resulted in a higher discount rate being used.¹¹⁹ Police and fire would face no cuts but reduced COLA increases whereas general employees would get a 4.5% cut in benefits and COLA increases would be eliminated.¹²⁰ Additionally, several of the major bondholders have similarly agreed on the plan, which still has some holdouts but will go to Judge Rhodes for approval.¹²¹ Although the final outcome depends on the votes and the legal process, the existence of bankruptcy held a major influence on the negotiation process and appears to have prompted the unions to agree to a settlement.

E) STATES ARE NOT ELIGIBLE TO DECLARE BANKRUPTCY

Although much of the focus on bankruptcy has focused on municipalities like Detroit, states themselves cannot declare bankruptcy. Under the Federal bankruptcy code, a state government does not fit the definition of an eligible municipality and therefore neither Chapter 9 nor any other part of the code can be used. This limits the ability of state governments because regardless of the Detroit case, bankruptcy will not be available to modify pension benefits.

Some have proposed allowing states to declare bankruptcy but this would be very challenging. Constitutionally, states are considered sovereign, which requires a change in the

¹¹⁸ Nathan Bomey, Matt Helms & Susan Tompor, *Detroit Pension Leaders, City Reach Landmark Deal on Retiree Cuts*, Detroit Free Press, Apr. 16, 2014, <http://www.freep.com/article/20140415/NEWS01/304150090/Detroit-bankruptcy-pension-deal-Kevyn-Orr>.

¹¹⁹ Id.

¹²⁰ Id.

¹²¹ Id.

current law done in a way to avoid the same constitutional problems arising from the protection of state sovereignty. There is already pressure in Congress to pass legislation that would give states this option and include it in the Federal bankruptcy code.¹²² Several prominent politicians such as former Florida Governor Jeb Bush and former Speaker of the House Newt Gingrich have spoken out in favor of such a proposal.¹²³ However, there has yet to be much political support to turn this proposal into a reality.

A potential version of such a law would likely follow similar logic as used by Judge Rhodes in the Detroit bankruptcy eligibility decision to avoid constitutional challenges. Professor Skeel believes that a successful version can be based on the existing Chapter 9 authorization for municipalities but expanded to states. Similar to the consent argument presented in the Detroit case, the argument is that unless a state is put into bankruptcy against its will, then there is no usurpation of state power by Federal law.¹²⁴ It therefore would be permissible for the Federal government to expand into state affairs since there is a Federal interest in doing so. Professor Skeel describes Medicaid as such an example in which the Federal government is not intruding on state power because the states are voluntarily consenting to participate in the program.¹²⁵ Similarly, consent would be crucial to allowing states to file for bankruptcy without violating the Constitution.

F) POTENTIAL NON-BANKRUPTCY SOLUTIONS

Without bankruptcy, fewer solutions are available for states and municipalities but some creative solutions have emerged. For example, James Spiotto, a bankruptcy lawyer at Chapman

¹²² Mary Williams Walsh, *A Path Is Sought for States to Escape Their Debt Burdens*, N.Y. Times, Jan. 20, 2011, http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?pagewanted=all&_r=0.

¹²³ Jeb Bush and Newt Gingrich, *Better Off Bankrupt*, Los Angeles Times, Jan. 27, 2011, <http://articles.latimes.com/2011/jan/27/opinion/la-oe-gingrich-bankruptcy-20110127>.

¹²⁴ David A. Skeel, *States of Bankruptcy*, 79 U. Chi. L. Rev., 677, 709, (2012).

¹²⁵ Id.

& Cutler, has proposed creating an entity known as the Public Pension Funding Authority. It would function as a commission or board that would determine necessary steps to restructure public pensions.¹²⁶ These entities would have to be created by state legislatures and in some cases through a state constitutional amendment and be structured to avoid any 10th Amendment challenges since participation would be voluntary.¹²⁷

He envisions such boards as being empowered to make changes or at least recommend changes including tax increases, increased contributions, or benefit reductions to protect the solvency and long-term sustainability of plans.¹²⁸ The boards would therefore be quasi-judicial independent entities with groups of experts appointed to solve the problem.¹²⁹ In some ways, it resembles the Municipal Assistance Corporation, a corporate entity created by New York City in the 1970s to deal with a fiscal crisis by issuing debt to lend to the city.¹³⁰ Similar ideas have emerged that also use some type of an outside control board to oversee and recommend changes.¹³¹ However, this faces skepticism from unions perceiving it as a way to avoid laws that protect pension benefits. Ultimately, these boards would face the same challenges in the legal system including state law protections either in their constitutions or under contract or property law. Therefore, the boards would still require enormous political capital in order to clear the hurdle of either a new statute or constitutional amendment.

CONCLUSION

¹²⁶ James E. Spiotto, *Unfunded Pension Obligations: Is Chapter 9 the Ultimate Remedy? Is There a Better Resolution Mechanism*, Chapman & Cutler, 33 (June 2011), available at <http://www.sec.gov/spotlight/municipalsecurities/statements072911/spiotto-slides2.pdf>.

¹²⁷ Id. at 36.

¹²⁸ Id. at 39.

¹²⁹ Id. at 36.

¹³⁰ Mary William Walsh, *Stepping Up With a Plan to Save American Cities*, N.Y. Times Dealbook, Nov. 11, 2013, <http://dealbook.nytimes.com/2013/11/11/stepping-up-with-a-plan-to-save-american-cities/>.

¹³¹ Tracy Gordon, *Bankrupt Reasoning: The Facts of State Bankruptcy*, Brookings Blog, Feb. 9, 2011, <http://www.brookings.edu/blogs/up-front/posts/2011/02/09-bankrupt-reasoning-gordon>.

The Detroit bankruptcy filing has merely brought more public attention to the issue of state and municipal financial troubles including challenges presented by underfunded public pension plans. Recent GASB changes in discount rate assumptions will result in even larger pension liabilities. Funding deficits are likely to make this an even bigger challenge for state and municipal governments in the years ahead even if they achieve high investment returns.

Yet the toolkit to make changes are limited. Strained budgets and political aversion towards tax increases make employer contributions difficult. Increased employee contributions or benefit reductions are limited due to state laws that provide constitutional, contract, or property protection for pension benefits. Although the specific laws vary by state, some of states with the biggest funding challenges such as Illinois and California face legal regimes that make such changes difficult to achieve.

Bankruptcy is a tool only available to municipal but not state governments and its use is currently being challenged in Federal courts. As the Detroit case progresses in the Federal appellate courts or is settled, state and municipal governments and public employee unions will be watching closely to learn to what extent bankruptcy is available as a tool to modify pension benefits.