



# THE PUBLIC SECTOR

## Vesting eclipsed by bankruptcy

by Jonathan Holtzman

A wise bankruptcy lawyer once said: “Bankruptcy is the worst option until it’s the only option.” That’s certainly true with respect to municipal bankruptcies—no sane person would argue that bankruptcy is a “good” option until there are no other alternatives. Such was the case when the city of Stockton recently filed for bankruptcy relief. However, Stockton’s early experience as it goes through bankruptcy does suggest that seemingly intractable issues, including vested contractual rights, are amenable to change through Chapter 9.

As part of its belt-tightening in the wake of bankruptcy, Stockton adopted what is referred to as a “pendency plan,” unilaterally modifying terms and conditions of employment for its current employees and modifying payments to its bond holders and other creditors. A pendency plan is an “interim survival mechanism that enables the financially embarrassed municipality, in the political and governmental judgment of its governing body, to continue to provide what it deems to be essential governmental services during the interval between the filing of a Chapter 9 case and the confirmation of a plan of adjustment.”

Through its pendency plan, the city reduced its contribution toward healthcare premiums for both active employees and current retirees—immediately reducing payments to retirees to \$150 per month for those with 10 to 20 years of service, \$300 per month for those with 20 to 30 years of service, and \$450 per month for employees with over 30 years of service. The pendency plan—and these significantly reduced contributions—became effective on July 1, 2012. The city also gave notice of its intention to discontinue subsidizing retiree health benefits entirely effective July 1, 2013.

On July 10, 2012, the Association of Retired Employees of the City of Stockton (ARECOS) and eight individual retirees filed an application for a temporary restraining order or preliminary injunction in the bankruptcy court, seeking to keep the city from reducing its retiree healthcare premium contribution. ARECOS contended that retirees have a vested contractual right to a fixed level of premium contribution from the city.

U.S. Bankruptcy Judge Christopher M. Klein, presiding over the city’s bankruptcy case, has now issued

a thorough and carefully reasoned opinion denying ARECOS injunctive relief. Judge Klein assumed for the purposes of his analysis (“but without deciding the question”) that “retiree health benefits are regarded as bargained-for and vested contractual rights.” ARECOS asserted that those rights are protected by the Contracts Clause of both the U.S. and California Constitutions and that by unilaterally modifying the benefits, the city impermissibly impaired its contractual obligation. Judge Klein, however, held that this impairment was permissible under the Bankruptcy Clause of the U.S. Constitution. As he put it: “While the Contracts Clause is a key navigational star in the firmament of our Constitution and economic universe, it is subject to being eclipsed by the Bankruptcy Clause.”

Judge Klein specifically held that contracts may be impaired in a Chapter 9 bankruptcy case without violating the Constitution because the Bankruptcy Clause gives Congress the power to legislate bankruptcy laws that result in the impairment of contracts. Indeed, he noted that the goal of bankruptcy is to modify or restructure contracts—resulting in their impairment—in order to readjust the creditor-debtor relationship, which hopefully allows the debtor to emerge from bankruptcy.

Judge Klein concluded that if he granted ARECOS’s request for a temporary restraining order requiring the city to renew its payments at their former levels, the court in essence would be interfering with the city’s political and governmental powers and dictating to the city how it should use its limited income. To do so would improperly expand the court’s limited authority under Chapter 9.

Judge Klein found that the proper remedy for the retirees is to participate in the process of negotiating a plan of adjustment. That provides retirees the ability to present their claims, have their claims evaluated, and accept, reject, or object to the plan. To that end, the city and its creditors, including the retirees, are scheduled to participate in additional mediation with a court-appointed bankruptcy judge to help “facilitate a negotiated solution.” Mediation is scheduled to take place sometime this fall.



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