10-1-2013

Can Pensions be Restructured in (Detroit's) Municipal Bankruptcy?

David A. Skeel Jr.
University of Pennsylvania, dskeel@law.upenn.edu

Can Pensions be Restructured in (Detroit's) Municipal Bankruptcy?

David A. Skeel, Jr.

Introduction

From the moment Detroit became the first major city to file for bankruptcy under Chapter 9, the provisions in the bankruptcy laws providing for municipal bankruptcy, it was clear that a key issue, possibly *the* key issue, in the case is whether Detroit's pensions can be restructured. Detroit's pension funds have insisted that pensions cannot be adjusted in any way; indeed, they sought to prevent Detroit from filing for bankruptcy based on the argument that the bankruptcy filing violated the Michigan Constitution because it could lead to the impairment of pensions. By contrast, Detroit's emergency manager, who took over most of Detroit's governmental functions in March, 2013, insists the Chapter 9 gives him the authority to dramatically alter Detroit's pensions.

The question whether pension obligations can be restructured in bankruptcy—and if so, to what extent and under what conditions—has steadily increased in urgency. As recently as five years ago, conventional wisdom held that political and legal obstacles made it impossible to restructure pensions in bankruptcy. Politically, the reasoning went, public employee unions are so politically potent a force that no city, even a city in bankruptcy, could afford to propose adjustments to pensions. Legally, many assumed that accrued pension benefits cannot be altered in bankruptcy, at least in states that protect pensions in their constitution, statutes, or caselaw.

One of the first hints of change came after Vallejo, California filed for bankruptcy in 2008. Officials in Vallejo believed that Chapter 9 gave them the legal authority to restructure public employee pensions, and gave serious consideration to proposing cuts. But under heavy pressure from CalPERS, which administers California pension funds, Vallejo backed off.[1] During this same period, two much smaller municipalities did alter their pensions. In 2009, Pritchard, Alabama tried to file for Chapter 9 but its case was kicked out. After halting payments on its pensions for two years, Pritchard settled with its pension beneficiaries, who agreed to reduce their pensions by roughly two-thirds.[2] Much more prominently, Central Falls, Rhode Island made clear when it filed for Chapter 9 in 2011 that restructuring its pensions was the only way the town could address its financial distress. Under its 2012 restructuring plan, Central Falls reduced its pensions by an average of 50%.[3]

Although the Central Falls case demonstrated that political obstacles will not invariably bar an effort to restructure pensions, the town's retirees and employees agreed to the restructuring. The court therefore did not need to answer the legal question whether pensions can be altered against the wishes of a pension beneficiary. The answer to that question will almost certainly come in Detroit's bankruptcy, the bankruptcy of either San Bernardino or Stockton California, or some combination of the three. Because there is no clear precedent on this issue, the odds are very high that the question will make its way to the Supreme Court either this term or next term.

This White Paper describes and assesses the question whether public employee pensions can be restructured in bankruptcy, with a particular focus on Detroit. Part I gives a brief overview both of the treatment of pensions under state law, and of the Michigan law governing the Detroit pensions. Part II explains the legal argument for restructuring an underfunded pension in bankruptcy. Part III considers the major federal constitutional objections to restructuring, Part IV discusses arguments based on the Michigan Constitution, and Part V assesses several Chapter 9 arguments against restructuring. None of these arguments appear to prevent restructuring. Assuming that pensions can in fact be restructured, Part VI discusses the

---

1 *See, e.g.,* Mary Williams Walsh, *Untouchable Pensions May be Tested in California*, N.Y. TIMES, March 17, 2012, at B1, available at http://www.nytimes.com/2012/03/17/business/untouchable-pensions-in-california-may-be-put-to-the-test.html?pagewanted=all&_r=0 (describing finance manager's conclusion that, if Vallejo tried to adjust its pensions, CalPERS would "fight us through the courts forever").

2 *Id.*

3 *See, e.g.,* Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES, Sept. 7, 2012, at A21, available at http://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html.

Chapter 9 factors that may affect the extent to which they are or can be restructured in a particular case.

I. The Status of Pensions Under State Law

A. Background and Current Legal Treatment

Pensions fall into two general categories. In a defined benefit plan, the public or private employer promises to make specified payments to an employee when he or she retires. In a defined contribution plan, the employer promises to make specified contributions. The employee generally decides how the contributions will be invested. Historically, defined benefit plans were the norm. Although defined benefit plans are increasingly rare in the private sector, they continue to be the norm for public sector employees.

In 1974, Congress passed the Employee Retirement Income Security Act (ERISA), which regulates private firms' defined benefit pension plans, and guarantees that, if the employer later terminates its pension plan, pension beneficiaries will receive a portion of the benefits they were promised under the plan. ERISA does not govern public employee pensions, however. It explicitly excludes governmental plans.[4]

Traditionally, nearly every state treated its pension promises to public employees as "gratuities."[5] This meant that the pension was a gift, and state lawmakers could change their mind about the pension at any time and for essentially any reason. Although two states (Indiana and Texas) continue to use versions of the gratuity approach, every other state now provides considerably more protection for their pension promises. Many states do this by treating the public pensions as contracts; a few states adopt a "property" approach.

---

4 29 U.S.C. sec. 1003(b)(1) (2000)).

5 This overview of the legal status of public pensions draws heavily on Amy Monahan's work, especially Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL. 617 (2010).

If a state adopts the contract approach, its pension promises are treated as a contractual obligation owed by the state or local government to participants in the plan. The key questions in a state that has adopted the contract approach are 1) when does the contract arise, or "vest"; and 2) what are the terms of the contract? The answer to the first question varies. Under some plans, the pension promise vests immediately; under others, the employee must work for a period of time before the rights vest, giving rise to a contractual obligation. The second issue, what exactly are the terms of the contractual obligation, has given rise to considerable litigation in recent years. A great deal turns on the answer, because pension promises that rise to the level of a contractual obligation are very difficult to adjust.[6] They are protected by the Contracts Clause of the U.S. Constitution, which forbids a state from impairing contractual obligations, and often by a (in most cases similarly worded) contracts clause in the state constitution. Contracts Clause protection does not impose an absolute bar to adjustment; but adjustments are only permitted under limited circumstances.[7]

A smaller group of states have interpreted their pension promises as creating a property interest.[8] A plan participant who has a property interest in a pension can challenge adjustments to the pension under the Takings and Due Process Clauses of the U.S. Constitution. In practice, there is more flexibility to adjust pensions that are treated as creating property rights than those that gives rise to contractual obligations.

As already noted, a number of states and localities have attempted to adjust their pension promises in recent years, due to concerns that the promises are unsustainable. Benefits that have

---

[6] In six of the contract states, the protections are based on provisions in the state constitution. The provisions in New York, Illinois, Alaska and Arizona have been interpreted as precluding any diminishment of benefits once an employee begins his or her employment, thus locking in both accrued and unaccrued benefits. Michigan and Hawaii protect an employee's accrued benefits. *Id.* at 10.

[7] The Supreme Court has long permitted some state interference with contracts, particularly the event of financial crisis. The classic case is *Faitoute Iron & Steel Co v City of Asbury Park,* 316 U.S. 502 (1942), which upheld a state statute that made a vote of bondholders to agree to a restructuring binding on all bondholders. *See* also United Automobile, Aerospace, Agricultural Implement Workers of America International Union v. Fortuna, 633 F.3d 37, 41 (1st Cir. 2011)(characterizing the cases as calling for an inquiry into whether "the state law has … operated as a substantial impairment of a contractual relationship" and "whether the impairment was reasonable and necessary to serve an important government purpose")(internal quotations removed). For a brief discussion of the Contracts Clause case law, see Stephen F. Befort, *Unilateral Alternation of Public Sector Collective Bargaining Agreements and the Contract Clause*, 59 BUFF. L. REV. 1, 22-25 (2011).

[8] "Connecticut, Wisconsin, Wyoming, Maine, New Mexico and Ohio courts have all ruled that public pension plans create protectable property interests." Monahan, *supra* note 5, at 24 n.27.

already accrued—that is, benefits related to a period of work that an employee has already completed—generally cannot be altered. At the other end of the spectrum, the state or locality can offer different terms to new employees. The key question is whether the state or locality can alter in any way the terms of the not-yet accrued benefits of existing employees. In a few cases, states or localities have successfully adjusted the unaccrued benefits promised to current employees, but the changes have generally been fairly minor, such as a decrease in the annual cost of living adjustments.[9] It is often impossible to make more significant adjustments under state law.

B. Michigan Pension Law

Michigan is one of the states that has adopted the contractual approach to public pensions, and has done so in its state constitution. In 1963, Michigan legislators explicitly placed state and local pensions on a contractual footing by adding the following section to Article XXIV of the Michigan Constitution:

> 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.
>
> Financial benefits arising on account of service rendered in each fiscal year shall be funded during that year and such funding shall not be used for financing unfunded accrued liabilities.[10]

It is important to note the context in which this constitutional amendment was adopted. Prior to the adoption of this protection, pension obligations were treated as gratuities in Michigan as elsewhere. Michigan or one of its cities, school districts or other state entities could promise

[9] *See, e.g.,* Mary Williams Walsh, *Two Rulings Find Cuts in Public Pensions Permissible*, N.Y. TIMES, July 1, 2011, at B1, available at http://www.nytimes.com/2011/07/01/business/01pension.html(describing cases in Colorado and Minnesota). Under the so-called "California Rule," California makes it nearly impossible to alter the unaccrued benefits of existing employees. For a critical assessment of the California Rule, see Amy B. Monahan, *Statutes as Contracts? The "California Rule" and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029 (2012)
[10] MICH. Const. ART. XXIV, sec. 9.

pension benefits to employees, then revoke them at any time.[11] This meant that an employee who had worked for a school district or city for many years could suddenly find herself without any benefits at all if she were laid off or the school district or city decided to discontinue benefits. The constitutional amendment was designed to ensure that a school district or city could not simply change its mind about providing benefits.[12] The provision has been interpreted by the Michigan courts to permit pension modifications that would affect an existing public employee's not-yet accrued benefits, but would not allow any adjustment of accrued benefits.[13]

Whereas the first sentence speaks to the pension promise, the second, less frequently discussed sentence addresses the equally crucial question of funding. By its terms, this sentence requires Detroit and other Michigan entities to fully fund the benefits that accrue in a given year in that same year, and forbids the use of this year's funds to fund benefits that accrued last year or in earlier years. If Detroit had complied with this obligation under the Michigan Constitution, there would be no pension problem at all.[14] Its pensions would be fully funded. But Detroit has failed to comply, and its pensions are underfunded by $3.5 billion according to emergency manager Kevyn Orr's estimates.

The question posed by Detroit is this: what happens when a Michigan city has promised pension benefits to its employees—a promise protected by the first sentence in Article XXIV, Section 9—but has failed to fully fund the pensions as required by the second sentence and may

---

[11] *See, e.g., See, e.g.*, *Brown v. Highland Park*, 30 N.W.2d 798, 800 (Mich. 1948)(stating that "a public pension granted by public authorities is *not* a contractual obligation, that the pensioner has *no* vested right, and that a pension is terminable at the will of a municipality, at least while acting within reasonable limits").

[12] At the constitutional convention that led to the provision's adoption, the committee explained that the first sentence of the provision was designed "to give to the employees participating in these plans a security which they do not now enjoy, by making the accrued financial benefits of the plans contractual rights. This, you might think, would go without saying, but several judicial determinations have been made to the effect that participants in pension plans for public employees have no vested interest in the benefits which they believe they have earned; that the municipalities and the states authorities which provide these plans provide them as a gratuity, and therefore it is within the province of the municipality or the other public employer to terminate the plan at will without regard to the benefits which have been, in the judgment of the employees, earned." CONSTITUTIONAL CONVENTION RECORD 770-71 (Feb. 2, 1962)(Van Dusen statement).

[13] *See, e.g.*, In re Enrolled Senate Bill 1269, 389 Mich. 659, 209 N.W.2d 200 (1973). *See also Seitz v Probate Judges Retirement System*, 189 Mich. App. 445, 474 N.W.2d 125 (1991).

[14] In a 1996 case involving retired Michigan public school employees' benefits, the Michigan Supreme Court agreed with the plaintiff that the district's failure to fully fund may have violated the Michigan constitution, but held that it would not have the power to force compliance. Musselman v. Governor, 448 Mich. 503, 533 N.W.2d 237 (1995) (Musselman I), and Musselman v. Governor (On Rehearing), 450 Mich. 574, 545 N.W.2d 346 (1996) (Musselman II).

not be capable of paying the benefits in full? Can the obligations be restructured or the municipality pay pension beneficiaries less than the full amount?

Outside of bankruptcy, a municipality could make two kinds of arguments for relief from its obligation to pay underfunded pensions in full. The first is based on the funding obligation in the Michigan Constitution that we have just discussed. The reasoning goes like this: because the Michigan Constitution only permits pension beneficiaries to be paid from benefits set aside during their years of work, their benefits are limited to funds set aside during this period. They are not entitled to be paid from other funds. Thus, not only can the pension obligations be limited to funds set aside during the years of the employee's employment, the obligations must be limited in this way.

A second argument for restructuring the obligation is that the promise not to impair pension obligations and an additional commitment in the Michigan Constitution not to impair contracts is subject to the implicit exception in the event of financial emergencies discussed earlier.[15]

If Michigan's Constitution is construed literally, the first argument is quite strong. Article 24 quite clearly requires that funding be set aside each year, and does not permit subsequent funding to be used for previously incurred obligations. But no Michigan court appears to have held that pension benefits are capped at the amount set aside for them each year, and Detroit and other Michigan municipalities have routinely violated this provision. It is possible that a court considering the argument in the context of a severe crisis like Detroit's would hold that the benefits are limited, but also possible that a court would rule that the constitutional obligation does not exhaust a municipality's payment responsibility. A court might conclude, for instance, that the funding requirement forbids other *pension* funding from being used for earlier pensions,[16] but that the municipality still is required to fulfill the obligations with non-pension funding if it can.

[15] *See supra* note 7.
[16] *See, e.g.,* Kosa v. Treasurer of State of Michigan, 292 N.W.2d 452, 408 Mich. 356 (1980)(holding that use of funded reserves to pay retirees whose benefits occurred before Article 24, section 9 was enacted was illegal and subject to mandamus).

The second argument is also plausible, and may be consistent with Contracts Clause precedents. But it is hard to imagine a court accepting the argument absent state legislation facilitating the restructuring by providing for a binding vote by pension beneficiaries. Both the legislation and a successful vote are unlikely, and federal bankruptcy law purports to forbid such voting provisions.[17]

Overall, it is difficult or impossible to restructure accrued obligations outside of bankruptcy under Michigan law, even if they appear to be unsustainable.[18] In Chapter 9, by contrast, a city has much clearer authority to restructure unfunded pension obligations.

II. Chapter 9 and the Restructuring of Pensions

A. The Chapter 9 Context

Chapter 9 is the provisions of the bankruptcy laws that permit a financially distressed municipality to restructure its obligations.[19] Chapter 9 borrows concepts from both personal and corporate bankruptcy. Much as in corporate bankruptcy, the municipality negotiates the terms of a restructuring with its creditors, and each class of creditors then votes on the proposed restructuring. As in personal bankruptcy, bankruptcy discharges the debtor's obligations but cannot put new decision makers in place.

The key differences between municipal and other bankruptcies stem from the fact that municipalities are creatures of the states, which have sovereign status. A municipality cannot file for bankruptcy unless the state has given explicit authorization, which slightly more than half

[17] 11 U.S.C. sec. 903(1) invalidates state law composition procedures, but it is unclear whether the prohibition would apply outside of bankruptcy.

[18] Michigan's attorney general reaches the same conclusion in a recent filing in the Detroit bankruptcy, but then goes on to conclude that accrued benefits also cannot be adjusted in Chapter 9, a conclusion that appears to be incorrect. Attorney General Bill Schuette's Statement Regarding the Michigan Constitution and the Bankruptcy of the City of Detroit (Aug. 19, 2013), at 10-15.

[19] Chapter 9 is set forth in 11 U.S.C. sec. 901-946. Section 901(a) also incorporates a long list of other bankruptcy provisions into Chapter 9.

of the states have done.[20] The bankruptcy judge is prohibited from interfering with the municipality's political and governmental functions.[21] Among other things, this means that the judge cannot require the municipality to raise taxes or cut funding. A municipality also cannot be liquidated.

From its inception in the 1930s, municipal bankruptcy has been designed to facilitate a municipality's restructuring of obligations that could not be restructured outside of bankruptcy. In the 1930s, bonds were the principal concern. The treatment of bonds continues to be an important issue, but more recently the subject of this White Paper—whether public employee pensions can be restructured—has taken center stage.

B. Can Pensions be Restructured?[22]

The starting point for analyzing whether pensions can be restructured in Chapter 9 is the Supremacy Clause of the U.S. Constitution, which states that the "Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land."[23] The Supremacy Clause makes clear that Chapter 9 will prevail over state law of any kind—a state statute, judicial opinion or constitutional provision—if there is a conflict between the two. The supremacy of federal bankruptcy law only begins the analysis, however. It still is necessary to determine what federal bankruptcy law says about the treatment of pensions.

As with many types of obligations, Chapter 9 does not explicitly state how pensions are to be treated, but the basic principles are relatively straightforward. The analysis begins with the distinction between the pension promise, on the one hand, and payment priority, on the other.

---

20 *See* 11 U.S.C. sec. 109(c)(2)(requiring state authorization). Twenty-seven states authorize municipalities to file for bankruptcy, in some cases subject to significant conditions.

21 11 U.S.C. sec. 903 and 904.

22 I focus in this section on the foundational question of whether pensions can be restructured. The restructuring of pensions raises several other kinds of issues as well. There is a question whether the pensions are executory contracts or simply claims, for instance; and whether they are separate from employee's collective bargaining agreements. The decision whether the pensions are executory contracts does not appear to affect their ultimate treatment, and the pensions will probably be treated as separate from the collective bargaining agreement.

23 U.S. Const, Art. VI, sec. 2.

The pension promise is the amount that a city such as Detroit agreed to pay to its employees when they retire. Bankruptcy fully recognizes this promise, and would permit a pension beneficiary to file a claim in the bankruptcy case for the full value of the promised payment.[24] This does not necessarily mean that the claim will be paid in full. The order in which the claim is paid depends on the claim's priority, which depends in turn on the extent to which the pension has been funded.

Consider a simple example. Suppose that the present value of Detroit's promises to a particular retiree is $1000, and over the years Detroit set aside $700 to fund the obligation. The promise to the retiree is $1000, and the retiree would be permitted to file a claim for $1000 in Detroit's bankruptcy. But this does not mean that the entire $1000 is entitled to priority or guaranteed full payment. A bankruptcy court would probably conclude that the retiree has a property interest in the $700 that has been set aside, and that the $700 is fully protected, but that the $300 difference between the promise and the amount of funding is an unsecured claim that it not entitled to priority.[25] In effect, the retiree is like a creditor that has made a partially collateralized loan to the debtor. Like a creditor who has lent $1000 to the debtor and taken collateral worth $700 to secure repayment,[26] the retiree's claim would be divided into a secured claim ($700) and an unsecured claim ($300).[27] The secured claim would be fully protected, whereas the unsecured claim would be subject to restructuring.[28]

This analysis is not entirely free from doubt. It is possible that a court would conclude that the retiree's property interest consists of the entire $1000 promised by Detroit. But this seems unlikely for at least two reasons. First, it would treat the promise as creating a property

---

[24] *See, e.g.,* 11 U.S.C. sec. 501, 502.

[25] It is possible but in my view unlikely that the entire $1000 pension promise would be treated as an unsecured obligation. I consider this possibility below.

[26] This assumes that the creditor has properly "perfected" its interest in the collateral by, for instance, providing public notice in the real estate records (if the collateral is real estate) or Article 9 filing system (non-real estate).

[27] Bankruptcy provides for this bifurcation of an undercollateralized secured claim in 11 U.S.C. sec. 506(b)(incorporated into Chapter 9 by 11 U.S.C. sec. 901(a)), which states that a claim is secured to the extent of the value of the collateral, and unsecured to the extent of any deficiency. Although public pensions are not explicitly subject to Article 9 of the U.C.C., which governs creation and perfection of security interests in personal property, or to real estate law, which operates on the same principles, a court would almost certainly apply similar reasoning.

[28] I have reached the same conclusion in other work. David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 697-99 (2012); David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 HOUSTON L. REV. 1063, 1072-74 (2013).

interest, even if there is no property to which the property interest refers. This is at odds with the way property interests are created in other contexts. Second, by explicitly requiring that adequate funding be set aside each year, the Michigan Constitution itself seems to recognize a distinction between the promise and the priority. The first part of the provision speaks to the promise, while the second part instructs the state and its municipalities to set aside funding—the "collateral" that determine the extent of the retiree's priority. Based on this reasoning, a court is very likely to conclude that pensions are fully protected to the extent they are funded, but unsecured to the extent of any deficiency.

The treatment of private pension claims provides further support for this conclusion. When the Studebaker car company failed in the early 1960s, its pension plan for employees was underfunded. Although Studebaker's pension beneficiaries argued that they were entitled to payment in full when the company was liquidated, they were treated as priority creditors only to the extent the pension plan was funded. As a result, they received far less than full payment.[29] Concern about the potential hardships this could cause was one of the factors that eventually spurred Congress to enact ERISA. ERISA does not fully protect pension beneficiaries, but it guarantees a majority of their benefits when a company that has a defined benefit plan terminates its plan due to financial distress.

I have assumed thus far that a court would treat pension beneficiaries as having a property interest in the funds set aside for their pensions, just as a secured creditor has a property interest in the collateral securing its repayment. But the funds set aside for pensions differ from ordinary collateral in an important respect. Unlike with ordinary collateral, the funds are not specifically identifiable, since money is fungible; and unlike with real estate or security interests under Article 9 of the Uniform Commercial Code, there is no formal mechanism for establishing and perfecting a property right in the funds. As a result, it is possible that a court would conclude that pension beneficiaries do not have any property interest in the funds, and thus that their entire claim is unsecured. If this were the case, the entire claim would be subject to restructuring. The key factor in this determination is whether actual funds have been set aside

---

[29] *See, e.g.,* Roger Lowenstein, *The Long, Sorry Tale of Pension Promises*, WALL ST. J., Sept. 21, 2013, at C3 (describing Studebaker collapse).

for the pension and segregated from other public funds. If the pension's funding is clearly distinct from the municipality's or other state entity's funding, a court is much more likely to conclude that pension beneficiaries have a protected property interest in the funds, much as investors have a property interest in a sinking fund set aside to pay a corporation's obligations to them.[30] If there is no actual funding set aside, by contrast, as with social security benefits, a court is much more likely to conclude that the pension beneficiaries do not have any property interest.[31] Detroit's pensions appear to fit the former category. Detroit's two major pensions receive and invest specific funds. A court is therefore likely to conclude that Detroit's pension beneficiaries have a property interest in the funds that have been set aside (and assets acquired with them).[32]

If the analysis above is correct, a plan that is fully funded—as the Michigan Constitution purports to require—will not be subject to restructuring. But if the plan is underfunded, the unfunded portion can probably be restructured, unless some other legal requirement precludes restructuring. In the next three parts, I consider the most important arguments against this conclusion.

III. U.S. Constitutional Issues: The Takings and Contracts Clauses

The discussion in the last part analyzed the basic treatment of public pensions in bankruptcy, concluding that the funded portion is likely to be protected and the unfunded portion subject to restructuring. In this part, I consider two clauses of the U.S. Constitution—the

[30] Alternatively, a court might conclude that the pension fund assets do not belong to Detroit and its creditors, and thus that only pension beneficiaries have a claim to them. Based on similar reasoning, courts have enforced restrictions on grants to nonprofit hospitals and other charitable organizations. *See, e.g., In re Joliet-Will County Community Action Agency*, 847 F.2d 430 (7th Cir. 1988) (restricted grants made by federal and state agencies were not property of the debtor's estate); *Parkview Hospital v. St. Vincent Medical Center*, 211 B.R. 619 (Bankr. N.D. Ohio)(funds donated to hospital for a particular purpose were not property of the hospital's bankruptcy estate).

[31] A failure to segregate the funds in any way might also lead a court to conclude that the pension beneficiaries do not have a property interest. *See, e.g., In re County of Orange*, 191 B.R. 1005, 1015-16 (Bankr. C.D. CA. 1996)(concluding that beneficiaries of a trust do not have a property interest if they cannot trace their funds).

[32] For the same reasons, the pension beneficiaries' Takings Clause arguments would be much stronger for the funded portion of their benefits, than for unfunded portions. The Takings Clause is discussed below, in Part III(A).

Takings Clause and the Contracts Clause—that might seem to preclude restructuring of a pension in bankruptcy. Both are plausible, but neither is likely to prevent restructuring.

A. The Takings Clause

The Takings Clause of the U.S. Constitution's Fifth Amendment states that: "nor shall private property be taken for public use, without just compensation." Pension beneficiaries and their representatives may argue that, once they have vested, pension rights are a property right that is protected by the Fifth Amendment.[33] Even if the pension is underfunded, the reasoning goes, the entire promised amount is subject to Takings Clause protection. If this is the case, the unfunded portion could not be restructured unless pension beneficiaries were compensated for the lost benefits.

The first thing to note about this argument is that Michigan has framed its treatment of pensions in contract terms, not property right terms. It is possible that a court would conclude that Michigan's characterization of the obligation as contractual precludes the use of the property rights analysis of the Takings Clause, but this seems unlikely. Pension beneficiaries appear to have a property interest in the funded portion of their pensions, as already discussed. The question is whether they also have a property interest in the unfunded obligations.

Even if Takings Clause analysis potentially applies, the argument that even unfunded obligations are protected probably would not succeed. In its Takings Clause cases, the Supreme Court has focused on the extent of a claimant's "investment backed expectations."[34] The strongest argument for full protection is that public pensions have rarely failed in the past. A pension beneficiary would not expect the plan to fail. But the pertinent question is what an investor's expectations would be for an underfunded pension in a time of financial crisis, not expectations in ordinary times. Given the similarity between a partially funded pension plan and a creditor with collateral that it worth less than it is owed, as well as the historical treatment of

---

[33] The Fifth Amendment's Due Process Clause may also be included as support for this argument.

[34] *See, e.g., Penn Central Transportation Co v City of New York*, 438 US 104, 124 (1978).

private pensions, a court is likely to conclude that the protected property interest consists of the funded portion of the pension. This also accords with the ordinary understanding of property.

B. The Contracts Clause

The Contracts Clause argument is more subtle. As discussed above, the Contracts Clause prohibits a state from impairing an obligation of contract. Because bankruptcy law is federal rather than state law, the Contracts Clause does not appear to apply directly. But pension beneficiaries and their representatives will argue (and have argued) that Chapter 9 facilitates a violation of contractual obligations by the state.[35] Detroit could not alter its pension obligations on its own; by permitting Detroit to alter the obligations in bankruptcy, the reasoning goes, Chapter 9 facilitates a violation by Detroit of the Contracts Clause.[36]

The Contracts Clause argument lay at the heart of the two Supreme Court cases that established the constitutionality of the predecessor of Chapter 9 in the 1930s. In the first of the cases, *Ashton*, which involved a small water improvement district, the Supreme Court struck down the first municipal bankruptcy law on Contracts Clause and state sovereignty grounds.[37] Two years later in *Bekins*, after Congress made relatively minor adjustments to the municipal bankruptcy law, the Supreme Court upheld the law, concluding that it did not violate the Contracts Clause or interfere with state sovereignty.[38] The Court characterized the law as "cooperation [by Congress] to provide a serious remedy for a serious condition in which the States alone were unable to afford relief."[39]

Because Chapter 9's purpose is to enable a municipality to restructure its obligations, a Contracts Clause challenge to the restructuring of pensions in Chapter 9 is essentially an

---

35 *See, e.g.,* The Michigan Council 25 of the American Federation of State, County & Municipal Employees, AFL-CIO and Sub Chapter 98, City of Detroit Retirees' Objection to the City Of Detroit's Eligibility to Obtain Relief Under Chapter 9 of the Bankruptcy Code, *In re City of Detroit, Michigan*, Case No. 13-53846, at para. 4 (Aug. 19, 2013).

36 I assume for this discussion that the Contracts Clause would indeed preclude Detroit from restructuring its obligations outside of bankruptcy. That is, I put to the side the possibility that the restructuring would be permissible, given Detroit's financial distress.

37 Ashton v. Cameron County Water Improvement District No. One, 298 U.S. 513 (1936).

38 United States v. Bekins, 304 U.S. 27 (1938).

39 304 U.S. at 53.

argument for overruling the *Bekins* decision and striking down Chapter 9 in its entirety. This is not quite as implausible as it may sound. The *Bekins* ruling came after the Court's famous "switch in time"—its apparent shift in 1937 from striking down New Deal legislation to a considerably more accommodating stance. The circumstances of the decisions—an adverse ruling in 1936 followed by an upholding of very similar legislation just two years later—may suggest that the ruling is shakier than some. In objecting to Detroit's bankruptcy filing, Detroit's principal union has in fact already argued that Chapter 9 is unconstitutional.[40]

Despite these uncertainties, Chapter 9 is likely to withstand constitutional challenge. The first factor weighing in its favor is simply that its constitutionality has been treated as settled for seventy-five years. This does not guarantee a finding that Chapter 9 is constitutional, but it makes the overturning of *Bekins* somewhat less likely.[41]

A second factor is the internal structure of Chapter 9. A Chapter 9 restructuring plan can only be approved if it is in the "best interests of creditors."[42] If this provision is interpreted to mean that it must be better for creditors than the likely alternative outside of Chapter 9, it may accord with the Court's interpretation of the scope of the Contracts Clause, or at the least minimize the extent of bankruptcy's departures. In a time of crisis, the Contracts Clause suggests, creditors' claims can be restructured if this is better than the alternatives. So long as only financially stressed municipalities are permitted to file for bankruptcy, the best interests protection minimizes any interference with the Contracts Clause.

The third and most important factor is the Bankruptcy Clause in Article I of the Constitution, which gives Congress explicit authority to enact "uniform laws on the subject of bankruptcy."[43] Not only has the Supreme Court construed Congress's bankruptcy powers very

---

[40] *See, e.g.,* Steven Church & Sophia Pearson, *Detroit Retirees Say Bankruptcy Law Unconstitutional*, BLOOMBERG.COM, Sept. 11, 2013, available at http://www.bloomberg.com/news/2013-09-11/detroit-retirees-say-bankruptcy-law-unconstitutional.html.

[41] The U.S. Department of Justice relies heavily on this argument in its memorandum to the bankruptcy court defending the constitutionality of Chapter 9. United States of America's Memorandum in Support of Constitutionality of Chapter 9 of Title 11 of the United States Code, *In re City of Detroit, Michigan*, Case No. 13-5346 (Oct. 11, 2013).

[42] 11 U.S.C. sec. 943(b)(7).

[43] U.S. Const. Art I, sec. 8.

broadly, but it has suggested in a different context that the Bankruptcy Clause may sometimes trump state sovereignty concerns.[44]

Together, these factors suggest that the Supreme Court would uphold the restructuring of pensions in the face of a Contracts Clause challenge. Moreover, the explicit bankruptcy authority provided by the Bankruptcy Clause is sufficient to justify provisions that would not comply with the Contracts Clause if they were enacted by state legislators.[45]

Interestingly, even in the unlikely event the Court were to conclude that Chapter 9 raises Contracts Clause concerns, the restructuring of Detroit's pensions probably would not violate the Contracts Clause. It is well established that the Contracts Clause only forbids a state from restructuring contracts retroactively.[46] Pensions did not become contractual obligations in Michigan until 1963, when Michigan added the pension provision to its constitution. By this time, municipal bankruptcy had long been in place, and Michigan had explicitly authorized its cities to use municipal bankruptcy since 1939.[47] Although one can imagine arguments to the contrary,[48] a court would be likely to conclude that Michigan pension promises are subject to restructuring even if the restructuring of other obligations would raise Contracts Clause concerns.

I have focused on the Contracts Clause question rather than state sovereignty because the Contracts Clause is more directly relevant to the question whether pension obligations can be restructured in Chapter 9.[49] But Chapter 9 can be expected to withstand a state sovereignty challenge for similar reasons. Chapter 9 is carefully structured to minimize the intrusion on state

---

[44] *Central Virginia Community College v Katz*, 546 US 356, 378 (2006).
[45] Note that Congressional involvement also softens concerns about the state restructuring its own contracts.
[46] Ogden v. Saunders, 25 U.S. 213 (1827).
[47] Mich. Public Act 72 (1939).
[48] In a thoughtful advocacy memorandum for creditors, Martin Bienenstock and Andrea Miller suggest that the 1939 authorization would not justify a restructuring of pensions because the voting rules under the municipal bankruptcy provisions in place in 1963 were more stringent than the current rules, and did not authorize a cramdown of dissenting creditors. Martin J. Bienenstock & Andrea G. Miller, *Situational Updates for Creditors: Michigan and Detroit's High Stakes Chapter 9 Constitutional Gambles* 28 (Oct. 2, 2013). Because the 1939 authorization appears to have been intended to incorporate any future municipal laws, it seems unlikely that a court would limit its application to the precise rules in place in 1939.
[49] The state sovereignty issue is addressed in more detail in David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677 (2012).

sovereignty. Only the municipality itself can invoke Chapter 9, and only if the state expressly permits a filing.[50] Chapter 9 also prohibits the bankruptcy judge from interfering with political or governmental functions.[51] These safeguards, together with Congress's Bankruptcy Clause powers, are likely to assure the constitutionality of Chapter 9.

IV. Other Issues Under the Michigan Constitution

We have already considered the implications of Michigan's constitutional protection for pensions for the question whether pensions can be restructured. Advocates for Detroit public employees have advanced two other arguments based on this provision and the contracts clause in the Michigan Constitution. They have argued that the state of Michigan is responsible for assuring full payment of Detroit's pensions, and that the legislation authorizing Detroit's bankruptcy filing violated the Michigan Constitution. Both are to some extent Michigan-specific issues, and neither speaks directly to the restructuring issue. But each has obvious implications for the status of Detroit's pensions.

A. Is Michigan Required to Guarantee the Detroit Pensions?

According to the first argument, the pension protection in the Michigan Constitution, the prohibition against impairing contracts in the constitution's contracts clause, or both, functions as a guarantee by Michigan of the pension promises of the state and all of its municipalities. Even if Chapter 9 permits the restructuring of pensions, the reasoning goes, Michigan is responsible for making up any shortfall, because the state would be impairing the pension by failing to make up the difference.

Although this argument cannot be dismissed out of hand, a court is highly unlikely to find it persuasive. As already discussed, the pension protection in the Michigan Constitution seems to have been designed to solidify Michigan's pension promise, not to directly or indirectly create

[50] 11 U.S.C. 109(c)(2)(state authorization); 901(a)(incorporating section 301, which provides for voluntary filings, into Chapter 9, but not section 303, which allows involuntary filings).
[51] 11 U.S.C. sec. 903, 904.

a pension priority. I have not seen any evidence that the provision was designed to make Michigan responsible for making good on a pension promise should a municipality be unable to do so. This conclusion is reinforced by the implausible implications of the argument that a promise not to impair makes the state a guarantor of the obligation. If the pension provision made Michigan a guarantor of all pensions, the same logic would suggest that the state contracts clause, which prohibits the state from impairing any contract, made Michigan a guarantor of every contract governed by state law—including both governmental contracts and (since the contracts clause also applies to private contracts) contracts between private parties. Certainly the state constitution has never been construed in this way.

B. Does Act 436 Violate the State Constitution?

The second set of arguments under the state constitution is stronger but also is unlikely to prevail. Advocates for public employees and other critics of the Detroit bankruptcy filing have argued that the emergency manager statute that authorized the governor both to put an emergency manager in place in Detroit and later to approve a Chapter 9 filing violates the Michigan Constitution. According to this argument, both enacting and invoking a law that permits a municipality to file for Chapter 9 violates the Michigan Constitution's protection of pensions.

Before addressing this issue, it will be useful to very briefly describe the emergency manager statute, Act 436.[52] Under the current version of the statute,[53] the governor is authorized to appoint an emergency manager after an investigation of a financially troubled municipality if the investigator concludes that the municipality is distressed. The emergency manager takes over many of the functions of the mayor and council (or other decision maker), and has the power to, among other things, modify or terminate collective bargaining agreements.[54] If the emergency manager concludes that these powers are not adequate to resolve the distress, he or

[52] The emergency manager provisions were enacted as Act 436 of 2012 (effective March 28, 2013), set forth in Mich Comp Laws § 141.1541-141.1575.

[53] The legislation was originally enacted in 1990. The emergency manager provisions were revised and significantly strengthened in 2011. Shortly after Michigan voters repealed the 2011 changes in November, 2012, the Michigan legislature enacted Act 436, a similar set of provisions.

[54] Id. section 12(j), codified at Mich Comp Laws § 141141.1552.

she may ask the governor for authority to file for Chapter 9.[55] Each of these steps was taken with Detroit earlier this year.

Public employee advocates have argued that these provisions violate the Michigan Constitution in several related ways.[56] Because emergency managers have the power to alter contracts, the provisions violate Michigan's prohibition against impairment of contracts; similarly, because they authorize the governor to approve a Chapter 9 filing that will impair contracts, the provisions are at odds with the constitution's provisions requiring the state to protect pensions and to protect other contracts.[57] I will focus on the authorization of Chapter 9, since that is more directly relevant to restructuring pensions in bankruptcy, and limit my comments on the constitutionality of the emergency manager provisions to the footnote that follows.[58]

There is a certain irony in arguments that the Michigan Constitution prohibits use of Chapter 9, since Michigan lawmakers figured prominently in the enactment of the original municipal bankruptcy law in the 1930s. Frank Murphy—then Mayor of Detroit and later Governor of Michigan and U.S. Supreme Court Justice—was one of its most prominent advocates, testifying in Congress in support of municipal bankruptcy and related legislation.[59] Even apart from the legal analysis, it would be odd if Michigan's 1963 constitutional changes cut off Michigan municipalities' access to Chapter 9.

---

[55] *Id.* section 18(1), codifed at Mich Comp Laws § 141.1558.

[56] In addition to the arguments discussed in the text, the statute has also been challenged as a violation of the Voting Rights Act.

[57] Michigan's attorney general has argued that Detroit's bankruptcy filing was permissible, but that the pension protection in Michigan's constitution precludes any restructuring of accrued pension benefits in Chapter 9. Attorney General Bill Schuette's Statement Regarding The Michigan Constitution and The Bankruptcy of the City of Detroit, at 2, *In re City of Detroit, Michigan*, Case No. 13-53846 (Bankr. E.D. Mich. Aug 19, 2013). A court is likely to reject this argument for the reasons discussed in the text that follows.

[58] The key question with the emergency manager statute is whether the contract alterations it permits can be justified under the financial distress exception to nonimpairment. The provisions appear to have been tailored to the exception, and to test its outer boundaries. For an argument that the right to terminate collective bargaining agreements, as embodied in the very similar 2011 version of the law, violated the contracts clause, see Kenneth Klee, Testimony at Emergency Manager Town Hall (Feb 21, 2012).

[59] *See, e.g.,* Hearing on before the Committee on the Judiciary of the House of Representatives, To Amend the Bankruptcy Act: Municipal and Private Corporations, 73d Cong. 1st Sess. 84 (March 30, 1933)(Testimony of Hon. Frank Murphy, Mayor of the City of Detroit, Mich.).

The legal analysis reinforces the conclusion that the Michigan Constitution does not prohibit a Chapter 9 filing that may result in the restructuring of pensions. More than two decades before the pension protection provision was added to the Michigan Constitution in 1963, Michigan had expressly authorized its municipalities to file for municipal bankruptcy.[60] The constitutional provision was enacted against this backdrop, and subject to this assumption.[61] More importantly, and as discussed earlier, the principal purpose of Michigan's pension protection was to protect the pension promise by preventing the state or a municipality from revoking the promise once made. The second part of the provision was concerned with priority, not the first. There does appear to be any evidence that either part of the provision was designed to cut off access to Chapter 9.

V. Do the Chapter 9 Confirmation Requirements Preclude Restructuring?

Even if Chapter 9 might plausibly authorize the restructuring of pensions, it is possible that its standards for the confirmation of a restructuring plan do not permit the restructuring of pensions. Two provisions in particular have been cited as possibly requiring that pension promises be paid in full under all circumstances: the requirements that a plan satisfy the dictates of nonbankruptcy law, and that it be the "best interests of creditors."

A. Section 943(b)(4): "Not Prohibited by Law"

Some advocates of public employees have argued that their pensions cannot be modified in bankruptcy because Chapter 9 only permits the bankruptcy court to approve a plan if "the debtor is not prohibited by law from taking any action necessary to carry out the plan."[62] Michigan does not permit pension obligations to be impaired. Therefore, the reasoning goes, any plan that proposes to restructure pensions would violate this provision, because the debtor would

---

[60] Mich. Public Act 72 (1939).

[61] As noted earlier, one could argue that the 1939 authorization referred only to the terms of the municipal bankruptcy law as of that time. *See* note 39 *supra.* But this seems a stretch. And the more important point, as discussed in the text that follows, is that the pension protection focuses on the pension promise; it does not speak to priority.

[62] 11 U.S.C. sec. 943(b)(4).

be effecting changes that are prohibited by state law.[63] Although this provision has not been interpreted by any appellate court, it is unlikely to be given the sweeping interpretation offered by employee advocates.

The first thing to note is that this interpretation would make Chapter 9 a dead letter. Under the Contracts Clause, a debtor is not permitted to impair any contract beyond the exceptions that have been carved out by the Supreme Court. In addition, the Michigan constitution has its own independent contracts clause.[64] A sweeping interpretation of Section 943(b)(4) would therefore suggest that almost no contract can be restructured in Chapter 9. Given that facilitating adjustments that would not be possible outside of state law is the principal point of Chapter 9, it would be quite surprising if a court were to adopt the sweeping interpretation of Section 943(b)(4).

In theory, one way to rescue a version of the sweeping interpretation would be to construe Section 943(b)(4) to preclude alteration of some but not all obligations. State constitutional obligations might be viewed as different than other obligations, for instance, due to their special status in state law and the higher barriers to enacting them. The obvious problem with this interpretation is that nothing in the language of Section 943(b)(4) invites a court to differentiate among obligations in this way. By its terms, it applies to laws of every kind.

The apparent purpose of Section 943(b)(4), and the way it is likely to be interpreted, is to apply after an obligation is restructured in Chapter 9, not to the restructuring itself. In the most thorough consideration of the provision to date, a bankruptcy court interpreted it in precisely this way.[65] In *Matter of Sanitary & Imp. Dist.*, bondholders challenged a proposed plan that would have restructured their bonds, and replaced them with bonds that provided for a buyback by the municipality at less than the full nominal value of the bonds. The court concluded that 943(b)(4) did not prevent a restructuring of the bonds. "To create a federal statute based upon the theory that federal intervention was necessary to permit adjustment of a municipality's debts and then to prohibit the municipality from adjusting such debt is not," the court concluded, "a logical or

[63] Professor Adam Levitin has made essentially this argument in a blog post. Adam Levitin, *What's Happening in Detroit*, CREDIT SLIPS, July 21, 2013, available at http://www.creditslips.org/creditslips/2013/07/whats-happening-in-detroit.html.
[64] Mich. Const Art. I, sec. 10.
[65] Matter of Sanitary & Imp. Dist., No. 7, 98 B.R. 970 (Bankr. D. Neb. 1989).

necessary result."[66] The restriction applied to the bonds as restructured, not to the restructuring itself.[67]

Other courts are likely to reach the same conclusion.[68] If they do, Section 943(b)(4) will not prevent a restructuring of public employee pensions.

B. The "Best Interests of Creditors" Requirement

Advocates of public employees also are likely to argue that requirement in Section 943(b)(4) that "the plan is in the best interests of creditors" prohibits Detroit from restructuring its pensions in any way.[69] Although the exact contours of this requirement are unclear, as with Section 943(b)(7), the best interests test also is not likely to prevent a pension restructuring.

Much of the uncertainty about Section 943(b)(7) stems from the fact that a municipality cannot be liquidated. In Chapter 11, an analogous "best interests of creditors" requirement explicitly requires that each creditor or shareholder be given at least as much under a proposed reorganization plan as the creditor would receive if the debtor were liquidated and the proceeds distributed to its creditors.[70] Because liquidation is not an option in Chapter 9, courts and commentators have struggled to define what the best interests requirement means. It presumably requires a court to consider the counterfactual question of what would have happened if the debtor had not filed for bankruptcy. Courts are likely to interpret the provision as requiring that

[66] *Id.* at 974.
[67] Because the bonds as restructured were subject to a provision allowing redemption at less than full value, the court concluded that they violated Nebraska law. *Id.* at 975.
[68] Only a handful of other courts have construed section 943(b)(4). *See, e.g.,* In re Barnwell Cnty. Hosp., 471 B.R. 849 (Bankr. D.S.C. 2012)(state prohibition against "dual offices" not violated); In re Bamberg County Memorial Hosp., 2012 WL 1890259 (Bankr. D.S.C. May 23, 2012)(restructuring properly authorized); In re Connector 2000 Ass'n, Inc., 447 B.R. 752 (Bankr. D.S.C. 2011)(applicable regulatory approvals obtained); In re City of Columbia Falls, Mont., Special Improvement Dist. No. 25, 143 B.R. 750 (Bankr. D. Mont. 1992)(state law did not prohibit impairment of bonds).
[69] 11 U.S.C. sec. 943(b)(7).
[70] 11 U.S.C. sec. 1129(a)(7).

the proposed plan be as beneficial to creditors as the likely outcome in the absence of bankruptcy.[71]

Pension beneficiaries will argue that anything less than full payment leaves them worse off than they would be outside of bankruptcy, since the Michigan Constitution requires that they be paid in full outside of bankruptcy. But this analysis is flawed, because it assumes that Detroit could plausibly come up with the money to pay its pensions in full. It is more likely that Detroit would have simply stop paying its pensions at some point. Given this possibility, the best interests test will not be interpreted as prohibiting any restructuring of pensions. It may limit the scope of potential restructuring, as discussed in the next part, but it will not prevent restructuring altogether.

VI. Applying the Chapter 9 Confirmation Requirements

I have analyzed in considerable detail the question whether public pensions can be restructured in Chapter 9, and have concluded that the funded portion of a pension is protected, while the unfunded portion is subject to adjustment. This does not mean that the entire unfunded portion can be simply wiped out in any given case. Even if Detroit or other municipal debtors wished to restructure pensions to the maximum extent, several Chapter 9 confirmation requirements would limit the scope of permissible restructuring. This part discusses the two most important: the best interests of creditors and unfair discrimination requirements.

A. The "Best Interests of Creditors" Requirement

[71] One bankruptcy treatise argues that section 943(b)(7) "should be interpreted to mean that the plan must be better than the alternative that creditors have," then cautions that a court should steer a middle course between assuming that the alternative would be chaos and little recovery, on the one hand, or assuming that the municipality should be expected "to devote all resources available to the repayment of creditors," on the other. COLLIER ON BANKRUPTCY, 943.03[7][a], at 943-26 & 943-27.

As discussed in the last part, the "best interests of creditors" test limits the extent to which the debtor's obligation to any given creditor can be restructured.[72] The precise test is unclear, but municipal debtors will probably be required to give their creditors as much as the creditor would end up with if the municipality had never filed for bankruptcy. Applying this test requires a great deal of speculation by the court. But in most cases, this will require the debtor to repay a nontrivial portion of its unsecured obligations.

Although Detroit's distress is particularly severe, it does have potential assets. For instance, the Detroit Institute of Arts has art worth billions of dollars. The parties have hotly contested the question whether the art is an asset in the bankruptcy case, with creditors arguing that it is and Michigan's attorney general insisting it is not.[73] Regardless of the conclusion, it is unlikely that paintings will be sold. But if the art is an asset in the case, its value may need to be reflected in the payout Detroit promises to its creditors. Even apart from the art and other assets, Detroit has some capacity to make repayments to its creditors. It does not have the capacity to pay them in full; if it did, Detroit never would have filed for bankruptcy. But it does have the ability to repay some portion of the unfunded portion of its pensions and other unsecured claims.

B. The "No Unfair Discrimination" Requirement

If a municipal debtor seeks to confirm a restructuring plan nonconsensually—that is, despite its having been rejected by one or more classes of creditors—the plan can only be approved if, among other things, it does not discriminate unfairly against the class or classes of claims that voted against the plan.[74] In Chapter 11, the no unfair discrimination requirement has long been construed to prohibit the debtor from giving one class of unsecured claims a much greater payout than another. The debtor generally cannot promise to pay one class 80% of what they are owed, for instance, and another 20%. The more similar the claims in the two classes are, the more likely a court is to insist on parity in the payouts of the two classes.

[72] It is worth noting that an individual creditor raise a best interests objection even if the class of creditors of which she is a part has voted in favor of the proposed plan.

[73] The attorney general's opinion is set forth in Bill Schuette, Attorney General, Opinion No. 7272, Conveyance or transfer of Detroit Institute of Arts Collection (June 13, 2013).

[74] 11 U.S.C. sec. 901(a)(incorporating 1129(b)(1).

This requirement may prove extremely important in a case like Detroit—much more important than commentators have recognized thus far. The no unfair discrimination stricture is perhaps the clearest illustration of bankruptcy's "equality of creditors" norm that similarly situated creditors will be treated similarly. This norm also gives rise to an expectation that sacrifice will be shared, rather than visited disproportionately on one or two classes of creditors. In Detroit, this means that the holders of Detroit's certificates of participation, its general obligation bonds, and its pension holders all are likely to be restructured to some extent.

No unfair discrimination does not mean that they must all receive exactly the same payout, however. No *unfair* discrimination is not the same thing as no discrimination. To the extent the attributes of classes of unsecured creditors differ, they can be given (somewhat) different treatment. This may permit Detroit to distinguish between the certificates of participation and GO bonds. The GO bonds were approved by a vote of Detroit's taxpayers and are subject to protection in the Michigan Constitution; the certificates of participation were not, and were generally viewed as more risky.[75] This suggests that Detroit could offer a somewhat higher recovery to the GO bonds without offending the "no unfair discrimination" requirement.

With the pensions, no unfair discrimination may allow Detroit to take into consideration the fact that Detroit's pensions are relatively modest, and that Detroit's pensioners are excluded from the social security system and thus do not have the same "backup" protection as most other workers. This, together with the constitutional protection for pensions, suggests that the obligations to pensioners stand on a somewhat different footing that obligations to ordinary unsecured creditors. It does not justify payment in full, but it may justify a higher payout than some classes of unsecured claims.

I noted at the outset of this section that the no unfair discrimination requirement applies to classes of creditors that have voted against a plan. Although it technically would not apply if every class of creditors voted in favor of a particular plan, the requirement will shape the

[75] *See, e.g.,* Martin L. Braun, *Detroit General-Obligation Bonds Seen as Paying 100%,* BLOOMBERG.COM, Aug. 16, 2013, available at http://www.bloomberg.com/news/2013-08-16/detroit-general-obligation-bonds-seen-paying-100-.html.

negotiations and will influence the terms that a debtor proposes even in cases where the plan is approved by every class.

Conclusion

In this White Paper, I have analyzed the question whether pensions can be restructured in bankruptcy, with particular attention to the issue as it has arisen in Detroit's Chapter 9 bankruptcy case. My analysis suggests that pensioners have a protected property interest to the extent the pension is funded, but that any unfunded portion will be treated as an unsecured claim that can be restructured in bankruptcy. Although there are a variety of arguments to the contrary under the U.S. Constitution, the Michigan Constitution, and Chapter 9 itself, and the issues have not yet been resolved by appellate courts or the U.S. Supreme Court, none of the arguments is likely to be prevent a restructuring. The extent of restructuring that is possible or desirable in any given case will depend on confirmation requirements such as the best interests of creditors and no unfair discrimination requirements.