



When the City Goes Broke: Pensions, Retirees, and Municipal Bankruptcies

Kevin M. Lewis

Legislative Attorney

April 10, 2018

In recent years, a significant number of cities, towns, and other municipalities in the United States have found themselves [increasingly unable](#) to pay their debts. In order to offer municipalities [relief](#) from many types of debts they cannot repay, [Chapter 9](#) of the [Bankruptcy Code](#) authorizes [certain municipalities](#) to [file for bankruptcy](#). However, filing for bankruptcy may adversely affect the municipality's creditors, especially [beneficiaries of underfunded municipal retirement plans](#) (who, along with bondholders, often hold "[the lion's share](#)" of a municipality's financial obligations). Because [a number of municipalities](#) face a "[dramatic and growing shortfall](#) in public pension funds," many "firefighters, teachers, police officers, and other public employees" who purportedly have "a right to pension benefits at retirement" face a significant risk that their pensions will ultimately [not be fully repaid](#). The fact that public pensions, unlike their private counterparts, are neither subject to the "[vesting and funding rules](#) imposed by" the [Employee Retirement Income Security Act of 1974](#) nor "protected by the federal pension guarantee program operated by the [Pension Benefit Guaranty Corporation](#)" could, according to some commentators, further exacerbate that risk. Moreover, because courts presiding over municipal bankruptcy cases have generally been "amenable to [modifying pension debt in bankruptcy](#)," retirees' pension benefits may potentially be [significantly curtailed](#) when a municipality declares bankruptcy. Although many Chapter 9 debtors have ultimately [opted not to cut pensions](#) "for [political or practical reasons](#)," courts and commentators [generally accept](#) that, [under certain circumstances](#), municipalities "[have the legal ability](#) to shed pension debt" in bankruptcy if they so choose.

This Sidebar first explains how, under current bankruptcy law, Chapter 9 debtors have significant freedom to modify their outstanding pension obligations through the bankruptcy process. The Sidebar then explores proposals to alter the legal principles governing the adjustment of municipal pensions in bankruptcy.

Congressional Research Service

7-5700

www.crs.gov

LSB10116

Background on Municipal Bankruptcy

Chapter 9 of the [Bankruptcy Code](#) authorizes municipalities to [file for bankruptcy](#) if they satisfy certain [eligibility requirements](#). A Chapter 9 case is designed to culminate in “a [plan](#) for the adjustment of the debtor’s debts” that [alters the financial relationships](#) between the municipality and its creditors. Chapter 9 thereby affords a [subset](#) of municipal debtors [relief](#) from many types of burdensome debts so that they may continue to provide certain [services](#) that have been viewed as “[essential](#)” to their residents, like police protection, fire protection, and garbage removal.

Filing for bankruptcy under Chapter 9 confers [many benefits](#) upon a municipal debtor. Most relevantly, [Section 365](#) of the Bankruptcy Code generally [gives a Chapter 9 debtor](#) the power to [reject an “executory contract”](#)—that is, a contract that the parties have [yet to fully perform](#)—subject to the [bankruptcy court’s approval](#). Rejecting a contract under Section 365 effectively constitutes “a [court authorized breach](#)” of the agreement that generally “[free\[s\] \[the debtor\]](#) from future performance under the rejected contract.” “The claims arising from this breach” are then generally “[subject to compromise](#) in bankruptcy” pursuant to a Chapter 9 plan that modifies the debtor’s obligation to pay those claims. This authority to reject executory contracts “is a [particularly powerful tool](#)” because it allows the debtor to effectively “disavow” certain contracts “that it no longer wishes to maintain.” One such contract [could be](#) a municipality’s commitments to provide pension benefits to its employees.

Pensions in Municipal Bankruptcy

As noted above, “many municipal debtors” face “overwhelming and seemingly unassailable [pension obligations](#).” However, several bankruptcy courts presiding over high-profile municipal bankruptcies (such as the Chapter 9 cases filed by the [City of Detroit](#) and the [City of Stockton](#)) have [agreed](#) that a municipality’s pension obligations “[may be adjusted](#) as part of a chapter 9 plan” by using Section 365’s rejection power described above. As a result, filing for bankruptcy under Chapter 9 thereby “[provide\[s\]](#) a means of [reducing](#) the unfunded liability portion of a municipality’s pension obligation or otherwise compromising a municipality’s pension debt.”

That is [not](#) to say that “public pensions can be rejected or unilaterally modified [willy-nilly](#),” however. Some bankruptcy courts, most notably the court presiding over the City of Stockton’s Chapter 9 case, have stated that a court must “[balance](#) the interests of the affected parties—debtors, creditors and employees”—to determine whether a debtor may permissibly “[us\[e\]](#) chapter 9 to force changes in municipal pension plans.” Specifically, the bankruptcy court “must [consider the consequences](#) of the alternatives” to adjusting the municipality’s pension obligations “on the debtor, on the value of creditors’ claims and any ensuing hardship and the impact on employees. The court also must consider the degree of hardship faced by each party and must consider any qualitative differences between the types of hardship each may face.”

Moreover, even when a bankruptcy court might otherwise be inclined to permit a municipality to adjust its pension obligations, “[political or practical](#)” concerns may nonetheless deter municipalities from using Chapter 9 to adjust their pension obligations. “[For example](#), it may be politically unpopular to treat debts owed to public workers in the same manner as sophisticated commercial lenders, or it may be difficult to continue the essential work of the city if employees feel that their employer’s promises cannot be trusted.” The fact remains, however, that municipalities potentially “have the [legal ability](#) to shed pension debt.”

Possible Considerations for Congress

Given that multiple bankruptcy courts have concluded that the Bankruptcy Code gives Chapter 9 debtors [significant](#) (albeit [not unlimited](#)) power to modify their pension obligations, commentators have [debated](#)

whether current bankruptcy law correctly balances the [competing interests](#) of debtors, retirees, and other creditors. [Some](#) have argued that municipalities presently enjoy too much freedom “to set aside collective bargaining agreements and retiree protections” to the detriment of workers “who have devoted their lives to public service.” Others, by contrast, have cautioned that affording pensioners favorable treatment in municipal bankruptcy cases could make lenders—who often “[battle](#) [with] retirees over the municipality’s scarce resources” in Chapter 9 cases—“[more wary](#) about loaning money to struggling cities,” which could, in turn, “increase borrowing costs for cities already in debt.”

Responding to this debate, some Members of the 115th Congress have introduced bills that would change how pensions are treated in municipal bankruptcy cases. For instance, the [Protecting Employees and Retirees in Municipal Bankruptcies Act of 2017](#) (H.R. 139) aims to “[strengthen\[\] protection for employees and retirees](#) under chapter 9 municipality cases” by (among other things) (1) making it [harder](#) for debtors to modify pensions and other retiree benefits over the objection of retirees and employees; and (2) imposing [stricter eligibility requirements](#) upon would-be Chapter 9 debtors, thereby narrowing the universe of municipalities that are eligible to modify their pension obligations through the bankruptcy process. As of the date of this publication, the bill is [pending](#) before the House Judiciary Committee’s Subcommittee on Regulatory Reform, Commercial & Antitrust Law.