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## Stockton health benefits not protected by the Contracts Clause

By David Kupetz / GUEST COLUMN

The city of Stockton unilaterally reduced the payment of retiree health benefits upon the commencement of Stockton's municipal debt adjustment case under Chapter 9 of the Bankruptcy Code. It is routine to suspend payment of various obligations during a bankruptcy reorganization case.

Stockton, Mammoth Lakes and San Bernardino have commenced Chapter 9 cases in recent weeks. Debt adjustment cases for municipal entities, however, have historically been far from routine and sparingly used. As a result, the powers of the municipal debtor and the limited powers of the court in a Chapter 9 case are generally not well understood.

Not surprisingly, a class action was promptly brought in the bankruptcy court on behalf of retired employees of the city of Stockton seeking an injunction requiring the city to pay for their health benefits during the Chapter 9 case. The retirees contended that they had vested contractual rights that are protected from impairment by the Contracts Clause of the U.S. Constitution, a similar clause in the state constitution, and by other provisions of state law.

The retirees were required to bring their class action in the bankruptcy court since an automatic stay precluding litigation or other actions outside of the bankruptcy court against the city of Stockton went into effect upon the commencement of the city's Chapter 9 case. Like Chapter 11 bankruptcy reorganization for non-governmental entities, the two primary benefits of a Chapter 9 case are (1) the breathing spell provided by the automatic stay, and (2) the ability to adjust the debts of creditors through the plan process. Chapter 9 provides a framework for eligible governmental entities to restructure debt. This is accomplished through confirmation of a plan of debt adjustment.

In an opinion issued on Aug. 6, the bankruptcy court presiding over Stockton's Chapter 9 case explained that the Bankruptcy Clause of the U.S. Constitution eclipses the

Contracts Clause and authorizes Congress to make laws that impair contracts. Accordingly, while a state cannot make a law impairing the obligation of contract, Congress has properly done so in the U.S. Bankruptcy Code. Moreover, the goal of the Bankruptcy Code is adjusting the debtor-creditor relationship. The court determined that, even if the retirees held vested property interests, "the shield of the Contracts Clause crumbles in the bankruptcy arena."

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The bankruptcy court further explained that Chapter 9 is designed to balance the powers provided under federal bankruptcy law to restructure a municipality's debt against the mandate of the 10th Amendment to the U.S. Constitution guaranteeing state sovereignty. The Bankruptcy Code embodies this balance by requiring that states authorize their municipalities to file Chapter 9 cases and severely restricting the powers of the bankruptcy court in a Chapter 9 case. Unless the municipal debtor consents or the municipal debtor's plan of debt adjustment so provides, the bankruptcy court is precluded from interfering with (1) any of the political or governmental powers of the debtor, (2) any of the property or revenues of the debtor, and (3) the debtor's use or enjoyment of any income producing property.

The bankruptcy court in the Stockton case found that the limitation on its power is absolute, subject only to the specified exceptions: consent of the municipality; and provision in a plan of debt adjustment. This is actually a single exception since in a Chapter 9 case only the municipal debtor may present a plan. Stockton did not consent to the court resolving the interim health benefit payment dispute and a plan of debt adjustment has not yet been

presented. Accordingly, the court explained that the Bankruptcy Code prevented it from doing what the retirees requested regardless of whether the city's action was fair since the court is powerless to interfere with property or revenues of a Chapter 9 debtor. The court held that, "although the City's unilateral interim reduction of retiree health benefit payments may lead to tragic hardships for the individuals in the interval before their claims are redressed in a chapter 9 plan of debt adjustment, the motion for injunctive relief must be denied."

The court instructed the retirees that their real remedy lies in participating in the process of formulating a plan of debt adjustment. While the plan can only be presented by the municipal debtor, it can be developed and shaped through negotiations. The court stated that "the lessons of recent chapter 9 cases teach that successful plans of adjustment are most likely to be achieved by the parties in interest all coming to the table and participating in bona fide negotiations." In the Stockton case, the bankruptcy court has appointed another judge as a standing mediator to attempt to facilitate a negotiated solution.

With respect to the retirees, the city's interim contractual modifications remain in place pending the confirmation of a Chapter 9 plan of debt adjustment, but those changes to the retirees' rights do not automatically become permanent unless made part of a confirmed plan of debt adjustment of otherwise voluntarily agreed. In summary, the Chapter 9 process involves the adjustment of financial relations between the city and all of its creditors, including the retirees, and is structured to culminate in the confirmation of a plan of debt adjustment that can provide for the impairment of contractual rights.



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