

PENSIONS AND PROPERTY RIGHTS IN MUNICIPAL BANKRUPTCY

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Abstract

Recent large municipal bankruptcies raise legal and moral questions of the priority in payment of the municipality's pension obligations. Focusing on existing law, we describe the bases on which pension obligations might have priority in bankruptcy. Priority under existing bankruptcy law requires that these obligations be supported by property rights effective outside bankruptcy. Part I identifies and rejects arguments that pension priority can be granted without property rights as part of Chapter 9 reorganization. Part II describes the requirement that pension priority be supported by property rights, identifies how statutory liens or trusts in favor of pensions can create priority, and describes the barriers to using these devices. A conclusion briefly describes revisions to the Bankruptcy Code that would allow pension priority, with or without property rights.

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Introduction

Recent large municipal bankruptcies have provoked public and scholarly interest in a fairly obscure area of bankruptcy law.¹ If we are lucky, a thriving economy will send municipal bankruptcy back into the shadows by reducing the demand for government expenses and increasing both tax revenues and the return on the investments that governments have set aside to pay their obligations to their retirees. However, if the economy stagnates or goes into another recession, many cities and counties could file for bankruptcy protection. Much of the prior literature describes municipal bankruptcy in terms of a conflict between citizens and bondholders.² The central question here is the limit on a court's ability to order political changes or make decisions that have significant political effects in administering a Chapter 9 case. However, the current batch of municipal bankruptcies is complicated by the presence of another type of major creditor: the retiree.³ The large full-service

¹ Historically, Chapter 9 bankruptcies have been relatively rare. See *Municipality Bankruptcy*, U.S. COURTS, <http://uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx> (last visited Apr. 16, 2014) (“In the more than 60 years since Congress established a federal mechanism for the resolution of municipal debts, there have been fewer than 500 municipal bankruptcy petitions filed.”).

² See, e.g., Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 FORDHAM URB. L.J. 639, 641 (2012) [hereinafter Gillette, *Bondholders and Municipalities*]; Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 319 (2012); Kevin Kordana, *Tax Increases in Municipal Bankruptcy*, 83 VA. L. REV. 1035, 1037 (1997); Richard C. Schragger, *Citizens Versus Bondholders*, 39 FORDHAM URB. L.J. 787, 787–88 (2012).

³ Estimates of the size of state and municipal pension obligations range from one to four trillion dollars. Robert Novy-Marx & Joshua Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FIN. 1211, 1231 (2011). Most of the difference in the estimates comes from the choice of discount rate used to adjust future obligations to present values. See *id.* at 1212–23. The lower estimates of liability use an accounting rule that allows a government to discount its future obligations at a rate equal to the return it expects to earn on the investments it sets aside to pay the obligations. *Id.* This accounting rule clearly conflicts with modern economic theory, which states that the obligations should instead be discounted at a rate that reflects the risk that the obligations will not be paid. *Id.* Because pension obligations are protected, the proper discount rate is

municipalities in bankruptcy have significant pension liabilities.⁴ Rather than focus on the conflict between citizen and creditor, this Article focuses on the conflict among creditors. The issue here is not how much the municipality should pay its creditors but which claims against the municipality should be paid first. It is one of priority among creditors.

Many believe that fairness requires that the law should grant retirees priority over bondholders, either because they need the money more or because bondholders can more easily bear the risk of non-payment.⁵ But not everyone agrees. Most notably, the Rhode Island legislature recently took steps to ensure that bondholders would have priority over retirees in municipal bankruptcy.⁶ We do not thoroughly engage this debate. Rather, we ask whether a judge can grant retirees priority consistent with existing bankruptcy law. Our focus on existing law is descriptive, not normative.

either the risk-free rate or the rate for municipal obligations backed by the government's full faith and credit. *See id.* at 1235. The higher estimates of state and municipal pension liabilities use this lower rate. *See id.* at 1213. A few commentators continue to defend the use of the high discount rate, but their arguments are unpersuasive. For example, Dean Baker has argued for the higher discount rate because cities and states are immune to market risks and can simply wait until the market improves. *Today, the Financial Health of Public Pensions*, ROOSEVELT INST. ECONOBYTES (May 2, 2013), <http://rooseveltinstitute.org/econoBYTES-thursday-may-2-2013> ("The reason is that a pension fund, unlike individuals, does not need to be concerned about the stock market's short-term fluctuations. State and local governments do not have retirement dates where they have to start drawing on stock holdings. They need only concern themselves with long period averages, without worrying about short-term fluctuations."). This assertion is in conflict with the plight of cities and states during the recent recession and municipal bankruptcies.

⁴ *See, e.g.*, CITY OF DETROIT, PROPOSAL FOR CREDITORS 109 (June 14, 2013), available at <http://detroitmi.gov/Portals/0/docs/EM/Reports/City%20of%20Detroit%20Proposal%20for%20Creditors1.pdf>; Tim Reid, *Bankrupt San Bernardino in Showdown with California Pension Fund over Arrears*, REUTERS (Oct. 29, 2013), <http://reuters.com/article/2013/10/30/us-usa-municipality-sanber-idUSBRE99T01020131030> ("The bankrupt city of San Bernardino and its largest creditor, the California Public Employees' Retirement System (Calpers), are set for a showdown over the city's \$17 million in pension arrears . . .").

⁵ *See infra* notes 102–04 and accompanying text.

⁶ *See* R.I. GEN. LAWS § 45-12-1 (Supp. 2013) (granting bondholders a statutory lien on a municipality's revenues).

Bankruptcy law begins with the principle of an equal distribution among creditors: creditors with claims having equal priority share equally in proportion to their claims.⁷ It nonetheless recognizes important departures from this principle of pro rata sharing, however. First, the Bankruptcy Code (or “Code”) sometimes grants some creditors priority over others. For example, the Code grants domestic support obligations priority over general creditors.⁸ Second, the Code recognizes contractual priority rights established between creditors. If one creditor agrees to subordinate its interest to another, bankruptcy gives effect to this agreement.⁹ Third, the Code recognizes non-bankruptcy law (typically state law) property rights that grant some creditors priority over others. For example, the Code recognizes the priority of a secured creditor over a general creditor with respect to its collateral.¹⁰

None of these departures from the principle of pro rata sharing provides retirees with priority that would ensure full payment of their claims in a municipal bankruptcy. The Code does not single out pensioners for priority in municipal bankruptcy,¹¹ and the municipality’s other major creditors might not agree to subordinate their claims to the pensions. Pensioners do not hold secured claims collateralized by funds the municipality has set aside to pay pension obligations.¹² Funds the municipality devotes to paying its pension

⁷ See *Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co.*, 547 U.S. 651, 667 (2006) (referring to “the equal distribution objective underlying the Bankruptcy Code”); *Sampsel v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) (“[T]he theme of the Bankruptcy Act is equality of distribution.”); H.R. REP. NO. 95-595, at 177–78 (1977) (“[T]he preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.”).

⁸ See 11 U.S.C. § 507(a)(1) (2012).

⁹ See 11 U.S.C. § 510(a).

¹⁰ See 11 U.S.C. §§ 506(b), 725, 1129(b)(2)(A).

¹¹ The Code provides a limited priority for unpaid wages, but the protections do not extend to pensions. See 11 U.S.C. § 507(a)(4).

¹² Although conceding that strictly the pensioners do not hold secured claims against the municipality, David Skeel finds it “almost certain[.]” that a bankruptcy court would consider them to have secured claims. David A. Skeel, Jr., *Can Pensions Be Restructured in (Detroit’s) Municipal Bankruptcy?*, 10 n.27 (Institute for Law and Economics, Research Paper No. 13-33, 2013) [hereinafter Skeel, *Can Pensions Be Restructured?*]; accord David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 697–98 (2012). We are not so certain. It is at least as likely that the pensioners will be considered to have claims on assets other than those

obligations instead are irrevocably contributed to a pension fund structured as a trust or its equivalent.¹³ Pension claims against the municipality can be satisfied from the financial assets of the trust or equivalent device acquired with the funds the municipality contributed to honor its pension liabilities.¹⁴ However, the municipalities that have entered bankruptcy have failed to contribute enough money to pay their pension obligations in full.¹⁵ In these cases, the pensioners have unsecured claims against the municipality to the extent that its pension obligations exceed the value of the assets held by the pension fund.¹⁶

Absent protections that give pension claims priority, can a bankruptcy court still award retirees a greater recovery than general creditors? The court can do so if all classes of creditors disadvantaged by the plan vote to approve it.¹⁷ Retirees have received a greater recovery than general creditors in some of the

owned by the municipality. This is because the pensioners are beneficiaries of trusts established under the municipality's pension plan and funded by the municipality's contributions. *See* Governmental Accounting Standards Bd., *Statement No. 67, Financial Reporting for Pension Plans*, GOVERNMENTAL ACCOUNTING STANDARDS SERIES, No. 327-B, June 2012, at 2 ("This Statement establishes financial reporting standards for state and local governmental pension plans—defined benefit pension plans and defined contribution pension plans—that are administered through trusts or equivalent arrangements . . . (hereafter jointly referred to as trusts) in which: Contributions from employers and nonemployer contributing entities to the pension plan and earnings on those contributions are irrevocable.") (footnotes omitted). Assets in these trusts are exempt from the claims of the municipality's creditors. *See id.* The trust assets remain outside the municipality's bankruptcy estate. *See infra* text accompanying notes 230–31. Thus, the pensioners could satisfy their pension claims from trust assets, to the extent of their value. The pensioners have unsecured claims against the municipality to the extent that their pension claims are greater in amount than the value of the trust assets. *See* 11 U.S.C. § 506(a)(1). A bankruptcy court does not have to stretch to the notion of a secured claim to protect pensioners.

¹³ *See* Governmental Accounting Standards Bd., *supra* note 12, at 2.

¹⁴ *See id.*

¹⁵ *See, e.g.,* Novy-Marx & Rauh, *supra* note 3, at 1218 (estimating the underfunded amount of the obligations at approximately three trillion dollars as of October of 2010).

¹⁶ *See supra* text accompanying note 12.

¹⁷ The unfair discrimination standard only protects those classes who vote against the plan. *See* 11 U.S.C. § 1129(b)(1).

municipal bankruptcies that have occurred to date because the plans of reorganization were approved by all classes of creditors.¹⁸ However, a municipality may be unable to achieve unanimous consent among classes in a large or complicated bankruptcy, and creditors may withhold their consent after considering what they would otherwise receive. It is therefore worth exploring the court's ability to approve such a plan over the objection of one or more class of creditors disadvantaged by the plan. If a class of creditors objects to the favorable treatment of pension obligations, the bankruptcy judge can only approve the plan if she finds that it does not "discriminate unfairly" against the classes of creditors who reject the plan.¹⁹

David Skeel, one of the leading advocates of the use of bankruptcy to resolve distressed municipalities, has argued that the judge can use this flexible standard to award a greater recovery to retirees because their destitution makes them more sympathetic.²⁰ We disagree. Although the meaning of the unfair discrimination limitation has been seldom litigated in Chapter 9, courts that have applied this standard in other reorganization chapters have refused to award more to sympathetic creditors on the basis of need.²¹ It is, of course, possible that the standard for unfair discrimination is different, and more forgiving, in Chapter 9 than in Chapters 11, 12,

¹⁸ See *infra* notes 118–22 and accompanying text.

¹⁹ 11 U.S.C. §§ 901(a), 1129(b)(1).

²⁰ See Skeel, *Can Pensions Be Restructured?*, *supra* note 12, at 25 ("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 . . . may justify a higher payout than some classes of unsecured claims."); Mary Williams Walsh, *Detroit Turns Bankruptcy into Challenge of Banks*, N.Y. TIMES, Feb. 4, 2014, at B7 ("Bankruptcy experts who are not involved in Detroit's case said it would, in fact, be possible for the city's pensioners to come at the top of the pecking order, even though they were on par with the general-obligation bondholders when the bankruptcy began. 'You can treat general creditors differently, as long as you have a good reason to treat them differently There's also a humanitarian interest in not wanting to cut the pensions severely as well,' Mr. Skeel said."). Skeel's claim also rests on the fact that pensions may enjoy greater protection outside of bankruptcy than other claimants. See Skeel, *Can Pensions Be Restructured?*, *supra* note 12, at 10 n.27. We reject this argument as well.

²¹ See *infra* Part I.B.

or 13. But this is unlikely. One could argue that the courts have been applying an unduly narrow construction of “discriminate unfairly” in the other chapters, but we find the possibility remote. In addition, we believe that there are good reasons to limit judicial discretion.

Although states have not granted retirees property interests that would give them sufficient priority to ensure payment, many states have adopted statutory or constitutional protections.²² The most plausible interpretation of these provisions is that they provide nothing more than a contract right similar to a municipal bond that everyone agrees can be modified in bankruptcy.²³ However, advocates for the retirees argue that existing statutory or constitutional provisions prohibit a municipality from taking any action that would diminish pension obligations.²⁴ They implicitly rely on the principle that bankruptcy law must respect priority rights established outside bankruptcy by state law. However, current law does not adopt this principle. Although bankruptcy law once explicitly recognized state law priority rights, Congress amended the Bankruptcy Act in 1938 to largely displace state law priorities.²⁵ The Bankruptcy Code continues to displace them too. Apart from special bankruptcy priorities, it recognizes non-bankruptcy priorities only if they are supported by property rights such as perfected security interests.²⁶ Bankruptcy law’s insistence on property rights as a condition of priority is a puzzle, but it is one that we do not have to solve. Our argument is positive, not normative. It therefore takes as

²² See *infra* notes 152–53 and accompanying text.

²³ This is the position that the court took in Detroit’s bankruptcy. See *In re City of Detroit*, Mich., No. 13-53846, 504 B.R. 97, 161 (Bankr. E.D. Mich. 2013); see also *infra* Part II.A.

²⁴ See, e.g., *McDermott v. Regan*, 624 N.E.2d 985, 987 (N.Y. 1993) (holding that statutory change in funding method for state retirement system is invalid as a violation of state constitutional protection of pension obligations against impairment); Complaint for Declaratory, Injunctive and Other Relief, at 47–79 *Harrison v. Quinn*, No. 2014-CH-000048 (filed Jan. 28, 2014), 2014 WL 309349 (arguing that statutory reduction of cost of living increases violates state constitutional protection of pension obligations against impairment).

²⁵ See *infra* notes 193–98 and accompanying text.

²⁶ See John D. Ayer, Michael L. Bernstein & Jonathan Friedland, *Chapter 11—“101” Priorities*, 23 AM. BANKR. INST. J., no. 6, July/Aug. 2004, at 18 (“[A] creditor with a valid and perfected security interest in property of the estate will have first dibs on that property.”).

given the assumption under current law that, absent a bankruptcy-specific priority, priority requires an enforceable property right.

If states find that their statutory or constitutional protections of pensions are not respected in bankruptcy because they are not property interests, they can create protections that are property interests.²⁷ Congress can do this at the national level as well. After all, Congress and states have granted priority to various claimants through the creation of statutory floating trusts or liens.²⁸ Existing bankruptcy law raises potential barriers to the enforcement of some property rights that give their beneficiaries priority, but these obstacles can be overcome with some careful planning.²⁹

The Article proceeds as follows. Section I describes bankruptcy law's tolerance of discrimination that favors pension obligations and its limits. Section II examines devices that allow state protections for pensions. Section III concludes.

I. Priority of Pensions in Chapter 9

In some of the municipal bankruptcies to date, pensions have either been left untouched or have received better treatment than other unsecured claims.³⁰ As we explain below, a municipality can grant workers and retirees preferential treatment in its reorganization plan as long as all of the other classes of creditors consent.³¹ The overwhelming majority of bankruptcy reorganizations are approved by consent.³² However, this consent occurs after negotiations that

²⁷ See *infra* Part II.C.

²⁸ See discussion *infra* Part II.C.1.

²⁹ See *infra* Part III.C.3.

³⁰ In the bankruptcy of Central Falls, Rhode Island, bondholders received full payment, while pension payments were cut by 55%. See Fourth Amended Plan for the Adjustment of The City of Central Falls at 13–21, *In re* City of Central Falls, R.I., No. 11–13105–FJB (Bankr. D. R.I. July 27, 2012), available at [http://centralfallsri.us/wp-content/themes/2012CF/assets/FinancialInfo/BankruptcyPlan/FourthAmendedPlan\(7-27-12\).pdf](http://centralfallsri.us/wp-content/themes/2012CF/assets/FinancialInfo/BankruptcyPlan/FourthAmendedPlan(7-27-12).pdf).

This is not an exception to the general principle, however, because Rhode Island had granted the bondholders a statutory lien. *Id.* at 23. Therefore, they were not unsecured creditors.

³¹ The unfair discrimination test only applies if a class rejects the plan, and even then it only protects disadvantaged classes that vote against the plan. 11 U.S.C. § 1129(b)(1) (2012).

³² See, e.g., MARK S. SCARBERRY, KENNETH N. KLEE, GRANT W. NEWTON & STEVE H. NICKLES, BUSINESS REORGANIZATION IN BANKRUPTCY: CASES

occur in the shadow of what the municipality can do in the absence of consent. This section explores the shape of this shadow.

As a general rule, the Code insists on a pro rata distribution among creditors, and one often finds language asserting that equality is a fundamental principle of bankruptcy.³³ This loose language is inaccurate, as the Code recognizes important exceptions to the rule of pro rata treatment.³⁴ None of these exceptions apply to the pension claims of the workers and retirees.³⁵

First, the various creditors may not actually be creditors of the same entity. Large public companies like General Motors are usually comprised of hundreds of corporations,³⁶ and some creditors may enjoy priority if they alone have rights against the corporation that actually owns the significant assets. This gives these creditors structural priority over other creditors because they have claims against property owned by a different debtor than the debtors against which other creditors have claims.³⁷ Structural priority is likely to play an important role in municipal bankruptcy as well, given that many municipalities contributed retirement funds to trusts or other

AND MATERIALS 994 (4th ed. 2012) (“Most plans are confirmed consensually under section 1129(a) of the Bankruptcy Code.”); Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization*, 66 J. FIN. 1253, 1274 (2006) (reporting that none of the confirmed Chapter 11 cases in a sample of business bankruptcies filed in Arizona and the Southern District of New York were cram downs).

³³ See *supra* note 7 and accompanying text.

³⁴ See 11 U.S.C. §§ 507(a), 725, 726.

³⁵ See *infra* text accompanying notes 44–47.

³⁶ See Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605, 619–20 (2011) (“[T]he 100 largest US public companies by revenues maintained an average of 109 foreign-nation subsidiaries, and . . . within the U.S. they had an average of 62 major subsidiaries outside Delaware (in addition to 74 incorporated in Delaware).”).

³⁷ Cf. Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 12 n.48 (2013) (“An investor who wants to protect itself by obtaining priority with respect to all these assets can do so, but it requires a variety of security interests. It is easier to segregate the assets for priority purposes by placing the assets in a separate subsidiary. By lending to the subsidiary, the investor obtains structural priority over any investors in the parent. Creating structural priority in this fashion may make it easier to securitize part of the revenue stream.”).

special entities that the retirees alone have claims against.³⁸ However, this does not provide sufficient help for the retirees because their pensions have been significantly underfunded.³⁹

Second, the Bankruptcy Code recognizes liens and other property rights that would give creditors priority outside of bankruptcy.⁴⁰ The bank that takes and properly records its mortgage will have priority over the general creditors with respect to the individual debtor's home, and the workman who has a mechanic's lien on the debtor's automobile will similarly have priority over general creditors.⁴¹ A court could find that the workers and retirees have a security interest in the assets set aside to fund the retirement benefits.⁴² Even if they do, however, there is not enough money to pay the retirement benefits in full if the pension obligations are not fully funded.⁴³ Third, the Code grants some creditors priority over others. For example, domestic support obligations, administrative expenses, and deposits made by consumers are granted priority over general creditors in a liquidation,⁴⁴ and many of these priority claims must be paid in full in a Chapter 11 reorganization.⁴⁵ However, the pension claims of workers are not priority claims.⁴⁶ Even if they had priority, Chapter 9 does not incorporate the provision of Chapter 11 that requires the full payment of priority claims.⁴⁷

Fourth, the Code will sometimes subordinate one creditor's claim to another's claim.⁴⁸ This is usually done because the subordinated creditor agreed to this treatment when the debt was issued.⁴⁹ In this case, the Bankruptcy Code is merely recognizing contractual rights that exist outside of bankruptcy.⁵⁰ To our

³⁸ See *supra* notes 12–14 and accompanying text.

³⁹ See *supra* note 15 and accompanying text.

⁴⁰ See 11 U.S.C. §§ 725, 1129(b)(2)(a) (2012).

⁴¹ See 11 U.S.C. §§ 725, 1129(b)(2)(a).

⁴² See, e.g., Skeel, *Can Pensions Be Restructured?*, *supra* note 12, at 10 n.27.

⁴³ See Novy-Marx & Raugh *supra* note 3, at 1235 (discussing how these rules “give special protection” to pensions).

⁴⁴ See 11 U.S.C. § 507(a)(1)(a)–(c).

⁴⁵ See 11 U.S.C. § 1129(a)(9).

⁴⁶ See 11 U.S.C. § 507.

⁴⁷ See 11 U.S.C. § 901(a) (listing the provisions of Chapter 11 that are incorporated into Chapter 9).

⁴⁸ See 11 U.S.C. § 509(c).

⁴⁹ See 11 U.S.C. § 510(a).

⁵⁰ See *id.*

knowledge, no significant creditors have agreed to subordinate their interests to those of the retirees. The Bankruptcy Code also explicitly allows the judge to subordinate a creditor's interests to those of another for equitable reasons,⁵¹ but bankruptcy courts cannot use this power to reorder statutory priorities.⁵²

A. Priority Outside the Plan

If we were describing a bankruptcy liquidation, we would have substantially completed our discussion of priority. However, Chapter 9 does not liquidate municipalities; it reorganizes them.⁵³ Whether they are individuals, corporations or municipalities, debtors must continue to operate before the reorganization is complete, and the debtor can use its freedom to operate to effectively prefer some creditors over others.⁵⁴ For example, bankrupt corporations routinely use their power to use their assets to pay certain so called "critical vendor" creditors in full on the first day of their bankruptcies, while creditors of equal priority must wait until the end of the process to receive pennies on the dollar.⁵⁵ Bankruptcy judges in some important bankruptcy districts approve these "first day orders" so that key

⁵¹ See 11 U.S.C. § 510(c).

⁵² See *United States v. Noland*, 517 U.S. 535, 543 (1996) (holding that equitable subordination on a categorical basis is inconsistent with the Bankruptcy Code's statutory priorities); *In re Burden*, 917 F.2d 115, 120 (3d Cir. 1990) (finding that while a court may subordinate certain penalties, it may not alter Congressional intent regarding such subordination). In addition, courts generally require a showing of misconduct by the party whose claim is being subordinated. See *In re Autostyle Plastics, Inc.*, 269 F.3d 726, 744 (6th Cir. 2001) (explaining the court's "three-part" equitable subordination test for cases involving misconduct); *In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977) (finding that misconduct must have "resulted in injury to the creditors").

⁵³ See 11 U.S.C. § 109(c)(4).

⁵⁴ See, e.g., *In re Mont Carbon Metropolitan Dist.*, 242 B.R. 18, 32 (Bankr. D. Colo. 1999) ("The purpose of a Chapter 11 reorganization is to restructure a business's finances so that it may continue to operate . . ."); *In re W.R. Grace & Co.*, 475 B.R. 34, 157 (Bankr. D. Del. 2012) (discussing how a bankruptcy reorganization plan could be structured to maximize the benefit for the creditors).

⁵⁵ See BARRY E. ADLER, DOUGLAS G. BAIRD & THOMAS H. JACKSON, *BANKRUPTCY: CASES, PROBLEMS AND MATERIALS* 444–45 (4th ed. 2007).

stakeholders continue to work with the firm.⁵⁶ The fear is that preferred suppliers would refuse to supply goods, and workers would leave the firm or destroy equipment if they did not receive their paychecks.⁵⁷

Bankrupt municipalities do not need to seek a first day order because they do not need court permission to use their funds.⁵⁸ Some argue that a municipality could use this power to pay certain creditors ahead of others.⁵⁹ This is the position that the court took in Stockton's bankruptcy when it ruled that the municipality did not need court approval to use its funds to settle a pre-petition tort claim.⁶⁰ As a practical matter, bankrupt municipalities will usually lack sufficient funds to pay meaningful amounts to their preferred creditors.⁶¹ They can borrow on an unsecured basis without court approval, but, given their insolvency, they are unlikely to find many willing lenders.⁶² Bankrupt municipalities may find more willing

⁵⁶ See Ryan K. Carney, *Bankruptcy—Pre-Plan Authorizations—Northern District of Illinois Prohibits First Day Orders and Pre-Plan Authorizations for Pre-Petition Debt*, 57 SMU L. REV. 473, 473 (2004) (providing general observations that “first day orders” are necessary to keep bankrupt entities “functional”).

⁵⁷ See ADLER, *supra* note 55, at 445.

⁵⁸ See 11 U.S.C. § 901(a) (excluding section 363 from the applicability of Chapter 9); 11 U.S.C. § 904(a) (stating the court's limitations when working with debtors).

⁵⁹ See Walter W. Miller, Jr., *Municipal Bonds in Chapter 9 Adjustment Proceedings*, WESTLAW J. BANKR., Mar. 24, 2013, at 1, 3–4.

⁶⁰ See *In re City of Stockton, Cal.*, 486 B.R. 194, 197 (Bankr. E.D. Cal. 2013). For a discussion of this dispute, see C. Scott Pryor, *Fairness and Risk in Stockton: Pensions, Bonds, and Taxes: When Doing Nothing Is Doing Good* 11 (unpublished manuscript) (July 23, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2297478.

⁶¹ See 11 U.S.C. §§ 109(c)(3), 101(32)(C) (insolvency requires that the municipality is generally unable to pay its debts as they become due); *In re City of Vallejo*, 408 B.R. 280, 289–90 (B.A.P. 9th Cir. 2009) (upholding the bankruptcy court's ruling that Vallejo qualified as insolvent within the meaning of section 101(32)(C)).

⁶² See 11 U.S.C. § 901(a) (excluding section 364(b)'s application in Chapter 9). Cf. Peter Molk, *Broadening the Use of Municipal Mortgages*, 27 YALE J. ON REG. 397, 406 (2010) (explaining the differences between private and municipal bankruptcies when seeking unsecured loans).

lenders if they offer collateral, but they need court approval to do so.⁶³

There may, however, be some circumstances in which an insolvent municipality does have access to significant funds. Consider Detroit. While Detroit is clearly insolvent, it owns artwork valued in the hundreds of millions if not billions of dollars.⁶⁴ Both the state of Michigan and several charitable foundations have expressed a desire to prevent these works from being sold off to satisfy the claims of creditors.⁶⁵ Assume that Detroit proposes the following two transactions. First, the city would sell the artwork to a charitable foundation, funded by a consortium of philanthropists and the state of Michigan, that would run an art museum in Detroit. Second, Detroit would then give the proceeds of the sale to its retirees. Section 363 requires that debtors receive court approval before using or selling assets outside the ordinary course of business.⁶⁶ The proposed transactions clearly are out of the ordinary course. Cities do not routinely sell hundreds of millions of dollars worth of artwork or contribute hundreds of millions of dollars to particular creditors.⁶⁷ Thus, if Detroit were a corporation in Chapter 11, it would need court approval for each of these steps.⁶⁸ However, Detroit filed for bankruptcy under Chapter 9, not Chapter 11, and section 363 does not apply in Chapter 9.⁶⁹ In addition, section 904(2) prohibits a court from “interfer[ing] with any of the property or revenues of the debtor.”⁷⁰ The conventional conclusion is that a court

⁶³ See 11 U.S.C. § 901 (incorporating section 364(c) into the applicability of Chapter 9).

⁶⁴ See, e.g., Randy Kennedy, Monica Davey & Steven Yaccinojan, *Foundations Aim to Save Pensions in Detroit Crisis*, N.Y. TIMES, Jan. 14, 2014, at A1 (“[Christie’s] auction house said that selling this portion [of Detroit’s art] would generate \$454 million to \$867 million. A group of creditors, including unions and financial institutions, is scheduled to challenge the appraisal in bankruptcy court next week.”).

⁶⁵ *Id.*

⁶⁶ 11 U.S.C. § 363(b)(1).

⁶⁷ See Kennedy, *supra* note 64, at A14 (discussing this “unusual” approach of charitable foundations trying to assist Detroit).

⁶⁸ See 11 U.S.C. § 363(b)(1).

⁶⁹ See 11 U.S.C. § 901(a) (excluding section 346(b) from the applicability of Chapter 9); see also *In re City of Detroit*, Mich., 504 B.R. 97, 97 (Bankr. E.D. Mich. 2013).

⁷⁰ 11 U.S.C. § 904(2).

cannot prevent Detroit from completing the transactions just described.⁷¹

Even if a court cannot stop these transactions, it might still be able to discourage a municipality from favoring some creditors over others by threatening to withhold approval of the municipality's plan of reorganization.⁷² This was the approach that the court took when Stockton proposed payments to some creditors in settlement of their claims.⁷³ The court noted: "The capital market creditors argue that unconstrained settlements amount to a creeping plan of arrangement. Perhaps so. Perhaps such a creep is legitimate and sensible. Perhaps nefarious. But, in any event, the day of reckoning comes at the plan confirmation hearing."⁷⁴

Indeed, bankruptcy law may require that the court reject a plan if these pre-plan payments mean that some creditors will receive a greater amount than others in the bankruptcy.⁷⁵ As discussed more thoroughly below, a court cannot approve a plan that "discriminates unfairly" against classes of creditors who reject the plan,⁷⁶ and courts will consider the total amount distributed in the bankruptcy in assessing this unfair discrimination.⁷⁷ The refusal to confirm a plan could be disastrous for the municipality for both its citizens and its creditors, including its retirees. This is because the municipality

⁷¹ See *infra* note 83 and the accompanying text.

⁷² See 11 U.S.C. § 901(a) (making section 1129(a)(3) applicable to Chapter 9); 11 U.S.C. § 943(b)(2) (conditioning confirmation on compliance with Chapter 9); *Town of Belleair, Fla. v. Groves*, 132 F.2d 542, 542–43 (5th Cir. 1942) (good faith lacking when municipality gave certain bondholders a benefit not given to other bondholders with the same priority); Alan Greenblatt, *Stockton Bankruptcy Case Defers Decision on Pensions*, NPR (Apr. 1, 2013, 5:10 PM), <http://npr.org/2013/04/01/175931395/stockton-bankruptcy-case-defers-decision-on-pensions> (discussing how a federal court disapproved of a bankrupt municipality favoring one creditor over another creditor).

⁷³ See *In re City of Stockton, Cal.*, 486 B.R. 194, 200 (Bankr. E.D. Cal. 2013).

⁷⁴ See *id.* at 199.

⁷⁵ See 11 U.S.C. § 1129.

⁷⁶ See *infra* Part I.B.

⁷⁷ See *Am. United Mutual Life Ins. Co. v. City of Avon Park, Fla.*, 311 U.S. 138, 143 (1940); Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 234 (1998) ("In short, unfair discrimination determinations require courts to consider all consideration received by a creditor on account of its claim, whether explicitly provided for in the plan or not.").

would not receive a discharge from its prepetition debts.⁷⁸ For this reason, the bankruptcy court in effect has the power to control the municipality's use of its assets to pay retirees. Thus, even if the court lacks the legal authority to control the municipality's spending, it can take measures that induce the municipality to limit its spending.⁷⁹ In any realistic (practical) sense, the court has power over the municipality's use of its assets in a Chapter 9 case.⁸⁰

We believe that the conventional conclusion that a court cannot prevent a municipality in bankruptcy from favoring some creditors outside its reorganization plan is mistaken. The Bankruptcy Code gives the court the authority to stop the municipality's use of its assets for this purpose.⁸¹ The court need not rely on its authority to do so indirectly, by denying the confirmation plan of a municipality that has favored some creditors over others outside the plan.⁸² Although section 904 prohibits a court from "interfer[ing] with the property of the debtor," section 901 incorporates in Chapter 9 the avoidance powers to police favoritism applicable in other bankruptcy chapters. In addition, section 926 gives the court the power to appoint a trustee to exercise these avoidance powers if the municipality refuses to do so. These avoidance powers include the power to nullify both certain pre-petition transfers, such as preferences (section 547) and fraudulent transfers (section 548), as well as certain post-petition transfers within prescribed limits (section 549).

Section 901's incorporation of section 549 appears to conflict with section 904. To date, most scholars have adopted a "maximalist" interpretation of section 904 that assumes that a court lacks the power to avoid a municipality's lawful transfer of municipal property.⁸³ Section 904 begins with the clause that states

⁷⁸ See 11 U.S.C. § 944(b).

⁷⁹ See *In re City of Stockton, Cal.*, 486 B.R. 194, 199 (Bankr. E.D. Cal. 2013) (warning that the court could police a municipality's spending at a "plan confirmation hearing").

⁸⁰ See *id.*

⁸¹ See 11 U.S.C. § 901(a).

⁸² See *supra* text accompanying notes 72–74.

⁸³ See, e.g., *In re City of Stockton*, 478 B.R. at 20 (relying on section 904's introductory language to conclude that the section's limitation on court authority to interfere with the municipality's exercise of its powers, including use of its assets, is absolute); cf. 6 COLLIER ON BANKRUPTCY ¶ 904.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011) [hereinafter COLLIER ON BANKRUPTCY] ("With two exceptions noted below,

“[n]otwithstanding any power of the court”⁸⁴ This introductory language perhaps suggests that section 904 trumps section 901. However, there are three problems with this maximalist position. First, this understanding of the relation between sections 904 and 901, which incorporates 549, leaves no application for section 549 in Chapter 9.⁸⁵ Good sense and the presumption against an interpretation that renders a statutory provision superfluous argue against this consequence.⁸⁶ Second, we doubt that a section 904 maximalist would really follow this reasoning to its logical conclusion. For example, section 901 also incorporates section 364(c) into Chapter 9. Section 364(c) requires that the debtor receive court approval before securing post-petition financing with collateral. However, the grant of collateral is a use of the municipality’s property. Thus, a maximalist reading of 904(2) would also leave no application for section 364(c). Third, a maximalist interpretation of section 904 yields a puzzling result. Section 904 is often justified as a means of avoiding difficult questions of state sovereignty in a federal bankruptcy system.⁸⁷ If this is its goal, the section accomplishes the goal imperfectly. After all, section 926 clearly allows a judge to appoint a trustee to undo political decisions to use municipal assets made just prior to the bankruptcy filing. It is odd that the judge’s power would be dramatically greater with

the prohibition of [section 904] is absolute [T]he question is only whether the order improperly interferes with the political or governmental affairs or property of the debtor. If it does, then no matter what authority is used to support it, the order runs afoul of section 904.”); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 463 (1993) (“The effect is to preserve the power of political authorities to set their own domestic spending priorities, without restraint from the bankruptcy court.”).

⁸⁴ 11 U.S.C. § 904.

⁸⁵ See COLLIER ON BANKRUPTCY, *supra* note 83, at ¶ 901.04[25] (“[Section 549] is unlikely to have any significant use in [C]hapter 9 cases.”).

⁸⁶ See *Corley v. United States*, 556 U.S. 303, 314 (2009) (“The Government’s reading is thus at odds with the most basic interpretative canon, that ‘[a] statute should be construed . . . so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant.’” (quoting *Hibbs v. Winn*, 542 U.S. 88, 101 (2004))); CALEB NELSON, STATUTORY INTERPRETATION 88 (2011).

⁸⁷ See, e.g., McConnell & Picker, *supra* note 83, at 463 (“[T]his principle of noninterference is an artifact of federalism rather than part of the inherent autonomy of local governance.”).

respect to transactions undertaken before the filing than for transactions that occur during the bankruptcy.

A “minimalist” reading of section 904 also can reconcile the section with section 549. According to this reading, 904(2) does not limit the court’s power to appoint a trustee to avoid post-petition transfers made by the municipality. Section 549(a)(2)(B) authorizes the trustee to avoid transfers that are “not authorized under this title or by the court.” Thus, the minimalist reading of 904 is that a court or trustee can avoid the municipality’s post-petition transfer of assets when the transfer is not authorized by either the Bankruptcy Code (“this title”) or the court. However, this reading of section 549 has its own problems. For one thing, it misunderstands the Code’s regulation of municipality’s use of its assets. As a technical matter, neither the Bankruptcy Code nor bankruptcy courts authorize any transfer of municipal property. This is because section 363 does not apply in a municipal bankruptcy.⁸⁸ The Code therefore does not give the municipality the power to use or sell assets. Non-bankruptcy law instead gives the municipality the power to do so. Thus, the assumption that section 549 applies to transfers not authorized by the Code makes no sense. In addition, this minimalist reading of section 904 can lead to absurd results. It would, for example, allow a bankruptcy judge to appoint a trustee to avoid payments the municipality makes for having the lawns mowed in the municipality’s park if the judge finds these payments unwise.

Neither the extremely broad “maximalist” understanding of section 904 nor the extremely narrow minimalist reading of section 904 make much sense as a matter of policy or statutory construction. A more moderate understanding of section 904 is preferable to either interpretation. Its reconciliation of sections 904 and 549 does not allow a judge to second-guess how much the city is spending on the mowing of city parks or a municipality to evade principles of equal treatment by paying favored creditors before the plan is approved. The moderate understanding of section 904 prevents a court from interfering with the city’s use of its assets, except when a Code provision authorizes interference (e.g., section 365) or the interference furthers the Code’s fundamental policies (e.g., section 549(a)(2)(B)).⁸⁹ This way of reconciling sections 549 and 904(2) is

⁸⁸ See 11 U.S.C. § 901(a) (omitting any reference to section 363).

⁸⁹ See 11 U.S.C. § 365(a) (requiring court approval for the trustee’s assumption or rejection of executory contracts and unexpired leases); 11 U.S.C. § 549(a)(2)(B) (stating that a “trustee may avoid a transfer of

attractive. It is consistent with the legislative history of section 904, which reveals a Congressional purpose to prevent a court from using its inherent powers to oversee the municipality's political or fiscal activities.⁹⁰ The moderate view also can handle otherwise problematic cases. No Code provision authorizes the trustee to avoid payments the city makes to have the lawns in its parks mowed. Payment also is not inconsistent with one of the Code's fundamental policies, and in fact likely furthers them. Thus, section 904(2) does not allow the court to interfere with that payment. On the other hand, the city's payment of pensioners is not "authorized" by the Code and is inconsistent with bankruptcy's principle of pro rata sharing.⁹¹ Section 549(a), therefore, allows the court, acting on the trustee's motion, to avoid payment to the pensioners.

Debtors also have the ability to assume executory contracts before a plan of reorganization is confirmed, and the counterparties to these contracts will not be forced to take a hair-cut.⁹² If a municipality could assume its pension obligations, it could effectively treat them better than its general obligations. Once again, however, there are significant problems with this strategy. First, a municipality may lack sufficient resources to honor its obligations to

property of the estate . . . that is not authorized under this title or by the court).

⁹⁰ Apart from its introductory clause ("notwithstanding any power of the court"), section 904 incorporates a virtually unchanged version of section 82(c) of the Bankruptcy Act of 1976. *Compare* 11 U.S.C. § 904, with H.R. Rep. No. 95-595, 94th Cong., 1st Sess., at 398 (1977) (emphasizing the need to limit the court's powers in light of *National League of Cities v. Usery*, 426 U.S. 835 (1976), since overruled, which held that the Tenth Amendment limits federal power to regulate labor contracts to which a state is a party). Congress apparently added section 904's introductory clause to limit the court's exercise of its powers not otherwise limited by sections 904(1)–(3), including its inherent powers derived from having jurisdiction over the case. *See In re City of Stockton, Cal.*, 478 B.R. 8, 18 (Bankr. E.D. Cal. 2012) (opining that Congress had intended to "confine its exercise of the bankruptcy power to measures that do not usurp state sovereignty"). The limitation does not apply to powers made applicable to Chapter 9 through section 901. *See* 11 U.S.C. § 901(a).

⁹¹ *See* 11 U.S.C. § 507(a) (providing the priority order of claims that fall under pro rata sharing); *see also In re City of Detroit, Mich.*, 504 B.R. 97, 162 (Bankr. E.D. Mich. 2013) (stating that the Michigan Constitution, not the Code, obligates the city to pay pensions).

⁹² *See* 11 U.S.C. §§ 365, 901(a).

its workers and retirees even if it got rid of all of its other debt.⁹³ The municipality, therefore, would at least need to renegotiate these obligations before assumption. Second, although the Code does not define the term “executory contract,” nearly all courts adopt Vern Countryman’s definition. According to this definition, a contract is executory if material obligations remain unperformed on both the debtor and its counterparty’s sides.⁹⁴ As a result, a municipality’s obligations to its retirees are not owed under executory contracts and cannot be assumed.⁹⁵

Another barrier to assumption is court authorization. Although the prevailing standard of judicial oversight of the trustee’s decision to assume or reject executory contracts is deferential, the limits of that deferential standard would be tested here.⁹⁶ The standard is on the order of the business judgment rule in corporate law.⁹⁷ The court will uphold the trustee’s decision to assume an executory contract unless no reasonable and disinterested person would decide to assume it based on the information available to the trustee.⁹⁸ Assumption requires the municipality to devote significant revenues in the future to funding its obligations to its retirees.⁹⁹ It

⁹³ See, e.g., Kennedy, *supra* note 64, at A1 (“By some estimates, [Detroit’s] pensions are underfunded by \$3.5 billion.”).

⁹⁴ See Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973); see also Pryor, *supra* note 60, at 28–29 (discussing case law that has adopted the Countryman definition).

⁹⁵ See *In re City of Stockton, Cal.*, 478 B.R. 8, 20 (Bankr. E.D. Cal 2012).

⁹⁶ See *Agarwal v. Pomona Valley Medical Group, Inc.*, 476 F.3d 666, 670 (9th Cir. 2007) (“[I]n evaluating the rejection decision, the bankruptcy court should presume that the debtor-in-possession acted prudently, on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the bankruptcy estate.”).

⁹⁷ See *id.* (stating that courts apply the business judgment rule when considering an executory contract rejection, and “its formulation in corporate litigation is appropriate here.”).

⁹⁸ See, e.g., *Agarwal*, 476 F.3d at 670 (calling for a “cursory” review of the decision to assume); *Moran v. City of Central Falls, R.I.*, 475 B.R. 323, 332 (D.R.I. 2012) (stating that judicial review is “limited to a determination whether such decision was made with sound business judgment”); Pryor, *supra* note 60, at 29–30 (collecting cases).

⁹⁹ See Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 92 (2013) (“There are many practical reasons to be cautious about bailing out public pension funds. The most obvious is that it would be very expensive.”); Steven Church & Steven Raphael, *Detroit Retirees Put on Notice in Bankruptcy Ruling*, BLOOMBERG (Dec. 3, 2013, 6:06 PM),

likely would detrimentally affect the municipality's credit rating, the willingness of creditors to lend, and the level of services the municipality can provide. The financial commitment required would likely render infeasible the implementation of any Chapter 9 plan.¹⁰⁰ The failure to confirm a feasible plan is not even plausibly in the interests of the estate or even the municipality's citizens. In this case a court could well wonder how assumption can be a sound business decision, even giving due deference to the trustee. It is doubtful that even the current deferential standard for the judicial authorization of assumption of executory contracts would allow assumption. There is a final hurdle for assumption. Just as a court could refuse to confirm a plan because the debtor distributed too much value to a creditor, it could also refuse to confirm a plan because the debtor assumed a contract on terms too favorable to the counterparty.¹⁰¹

B. Priority Within the Plan

Much of the existing commentary asserts that fairness requires that the pension obligations be paid in full or at least that they receive better treatment than other unsecured claims.¹⁰² Often this is asserted as a moral claim unrelated to existing bankruptcy law.¹⁰³ The focus of this Article is not on the moral case for the

<http://bloomberg.com/news/2013-12-03/detroit-to-remain-under-bankruptcy-protection-judge-says.html> (“[U.S. Bankruptcy Judge Steven] Rhodes cautioned . . . [that] any plan would have to meet bankruptcy code standards, and he would take into consideration how cuts would affect creditors, including retirees . . .”).

¹⁰⁰ See 11 U.S.C. §§ 901, 1129(a)(11) (2012).

¹⁰¹ See *In re City of Stockton, Cal.*, 486 B.R. 194, 199 (Bankr. E.D. Cal. 2013).

¹⁰² See, e.g., Beermann, *supra* note 99, at 92 (discussing the unfairness of not fulfilling pension promises and stating that those who receive income from pensions should be “entitled to at least as much consideration as financial institutions and government bankholders”); Pryor, *supra* note 60, at 36 (“Allocation of risk only to retirees and recipients of services is not fair.”).

¹⁰³ See Jack Lessenberry, *Pension Cuts in Detroit's Bankruptcy Plan Would Be Devastating and Unfair*, MICH. RADIO (Feb. 24, 2014), <http://michiganradio.org/post/pension-cuts-detroits-bankruptcy-plan>.

priority of pension obligations in bankruptcy.¹⁰⁴ Rather, we address the fairness required by the Bankruptcy Code.

The Bankruptcy Code contains two basic fairness tests: vertical and horizontal standards of equity. Most prior writing on municipal bankruptcy has focused on the test of vertical equity. This is the command that the plan be “fair and equitable.”¹⁰⁵ When a corporation tries to reorganize, this command means that the shareholders cannot receive anything unless the corporation’s debts

¹⁰⁴ As noted, our analysis is positive. But we enter a note about the normative case for pension priority. Some think that pension obligations should be paid first among general claims. *Id.* Theirs is a moral claim unrelated to existing bankruptcy law. This claim might be based either on the desert or the relative well-being of pensioners. While we do not suggest that the recommendation is wrong, we note a problem. An argument for giving pension obligations priority in payment must establish at least two things: that pensioners are morally entitled to payment, and that they are more entitled to full payment than other claimants. Thus, demonstrating that pensioners deserve to have the pension obligations owed them paid by the municipality is not enough. It also must be shown that these obligations should be paid ahead of other obligations the municipality owes to its general creditors. This is important because other general creditors, such as tort claimants or individual bondholders, might be equally or more deserving of having their claims honored in full. If other claimants are at least as deserving of full payment, the case for giving pension obligations priority is not made. Relative well-being presents a different problem. Here it must be shown that pensioners are worse off than other creditors of the municipality and that their relative position gives them a stronger moral claim to be paid than the other creditors. Given the range of financial circumstances in which different individual pensioners find themselves, the relative well-being of pensioners is unlikely to argue for the priority for all pension obligations. In sum, we are agnostic about the prospects of a moral argument for giving pension obligations priority in payment. For the theoretic basis of claims to priority, see THOMAS NAGEL, *MORTAL QUESTIONS* 122–25 (1979), and see generally Dennis McKerlie, *Equality and Priority*, 6 *UTILITAS* 25 (1994); Derek Parfit, *Equality and Priority*, 10 *RATIO* 202 (1997). For complications, see Roger Crisp, *Equality, Priority, and Compassion*, 113 *ETHICS* 745, 755–63 (2003).

¹⁰⁵ See 11 U.S.C. § 1129(b)(1) (“[I]f all of the applicable requirements of (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class or claims or interests that is impaired under, and has not accepted, the plan.”).

are paid in full.¹⁰⁶ Prior scholarship asks how this command would apply to a municipality, effectively asking how much a municipality and its taxpayers must pay to its creditors.¹⁰⁷ This is not our question. We focus instead on how these payments should be divided among creditors. The fair and equitable standard has something to say about this question as well. For example, it says that secured creditors must be paid in full before the collateral can be used to pay general creditors.¹⁰⁸ A few scholars have objected to this standard as applied to the bankruptcy of Central Falls, Rhode Island, because the state of Rhode Island granted bondholders a statutory lien on the assets of municipalities shortly before the municipality filed.¹⁰⁹ Transfers on the eve of bankruptcy that change priority are indeed troubling, and perhaps the court should have appointed a trustee to avoid the bondholders' lien.¹¹⁰ However, because the court failed to do so, the

¹⁰⁶ See 11 U.S.C. § 1129(b)(2)(C) (“With respect to a class of interests the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value . . . equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled . . .”).

¹⁰⁷ See, e.g., Gillette, *Bondholders and Municipalities*, *supra* note 2, at 655–57 (exploring whether residents or bondholders should get priority when municipalities enter fiscal distress); Kordana, *supra* note 2, at 1074–75 (discussing the difficulty of repaying debt and a model in which the government does not default on debt); McConnell & Picker, *supra* note 83, at 466–67 (discussing taxing the community when the municipality declares bankruptcy); Schragger, *supra* note 2, at 788 (“Who should bear the risk of a default—citizens through tax hikes or bondholders through losses?”).

¹⁰⁸ See 11 U.S.C. § 1129(b)(2)(A)(i)(I)–(II).

¹⁰⁹ See, e.g., Pryor, *supra* note 60, at 25–26.

¹¹⁰ The court could not have appointed a trustee to avoid these liens as preferential transfers because section 926(b) explicitly exempts transfers to bondholders from this avoidance power, and section 547(c)(6) exempts the fixing of statutory liens from this avoidance power. 11 U.S.C. § 926(b) (“A transfer of property of the debtor to or for the benefit of any holder of a bond or note, on account of such bond or note, may not be avoided under section 547 of this title.”); 11 U.S.C. § 547(c)(6) (“The trustee may not avoid under this section a transfer that is the fixing of a statutory lien that is not avoidable under section 545 of this title . . .”). Statutory liens can be challenged under section 545, but none of the grounds for avoidance clearly applied in *Central Falls*. Perhaps the best argument that a trustee could have made is that the fixing of the statutory lien was a constructively fraudulent transfer under section 548. The argument is weak in light of section 548(d)(2), which defines “value” to include the securing of an antecedent

Code's vertical equity test commanded that the bondholders receive priority over the retirees and general creditors.

The horizontal equity test is really two tests. To understand these tests, a bit more background in bankruptcy law is needed. Chapter 9 imports much of its structure from Chapter 11.¹¹¹ As under Chapter 11, the debtor proposes a plan of reorganization that puts claims into classes.¹¹² Claims can only be placed in the same class if they are "substantially similar"; they cannot be placed in the same class if one has priority over the other.¹¹³ However, the Bankruptcy Code gives the debtor some ability to put claims of equal priority in different classes, and pensions would almost certainly be placed in a different class than municipal bonds.¹¹⁴ This is important for two reasons. First, the Code insists on the equal treatment of claims within a class.¹¹⁵ This first test of horizontal equity goes beyond a

debt. *Accord* Uniform Fraudulent Transfer Act § 3(a). Based on this definition, bondholders give reasonably equivalent value for a statutory lien securing the city's obligations to them. This result nonetheless is controversial in the courts. Although some bankruptcy courts adopt a *per se* rule to the effect that collateral granted on account of an antecedent debtor is not a constructively fraudulent transfer, other courts disagree. They do not consider an antecedent debt always to count as reasonably equivalent value. These courts take into account the circumstances of the transfer to determine whether the debtor has received reasonably equivalent value for the collateral securing an antecedent debt. The circumstances can include consideration of whether the debtor received other value beyond an initial loan. *Compare In re AppliedTheory Corp.*, 330 B.R. 362, 363 (S.D.N.Y. 2005) (*per se* rule), *with In re Annand*, 239 B.R. 511, 518 (N.D. Ill. 1999) (reasonably equivalent value analysis depends on "all the facts of each case").

¹¹¹ See 11 U.S.C. § 901(a) (incorporating over thirty provisions from Chapter 11). Unlike Chapter 11, the Chapter 9 debtor has the exclusive right to propose a reorganization plan. *Cf. id.* (omitting the incorporation of section 1121 into Chapter 9).

¹¹² See 11 U.S.C. § 901 (incorporating section 1122, which classifies claims).

¹¹³ 11 U.S.C. § 1122.

¹¹⁴ See 11 U.S.C. § 1122(b); James E. Spiotto, *Chapter 9: The Last Resort for Financially Distressed Municipalities*, in *THE HANDBOOK OF MUNICIPAL BONDS* 145, 172–73 (Sylvan G. Feldstein & Frank J. Fabozzi eds., 2008) (different classification based on reasonable distinctions in claims appropriate).

¹¹⁵ See 11 U.S.C. § 1123(a)(4) (requiring equal treatment within a class unless the disfavored party agrees to a different treatment).

command that each receive value that represents a pro rata share of the estate. In addition to receiving equal value, each must receive the same consideration under the plan.¹¹⁶ Members of the same class must be paid in the same coin.¹¹⁷ As a result, if the municipality wants its bondholders to receive payment in the form of new bonds and its retirees to receive payment in the form of new pension obligations, they must be placed in separate classes.

The second test of horizontal equity is much weaker. The Bankruptcy Code prohibits the confirmation of a plan that “discriminates unfairly” against a class that votes against the plan.¹¹⁸ The most important fact about Chapter 9’s unfair discrimination standard is that it is an objection that must be raised by the holder of a claim that is a member of a class that voted against the plan; a creditor cannot object to a plan on these grounds individually.¹¹⁹ This means that a plan of reorganization can grant retirees preferential treatment if enough creditors within the disfavored classes consent so that these classes vote to accept the plan.¹²⁰ This has occurred in some recent municipal bankruptcies. For example, although Central Falls’ bankruptcy reduced the value of its pensions by about half while the bondholders (who had liens) were paid in full, the retirees still received more than general unsecured creditors.¹²¹ In addition, Central Falls’ reorganization plan imposed a floor so that no retiree’s pension was reduced below \$10,000 per year.¹²²

Even if creditors routinely consent to plans of reorganization, it is likely that they bargain in the shadow of what would happen in the absence of their consent. David Skeel has suggested that courts use the discretion afforded them by the Bankruptcy Code to protect impoverished pensioners by departing from the equal treatment principle.¹²³ He argues that unequal treatment could be justified based on the financial need of the

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ 11 U.S.C. §§ 901(a), 1129(b)(1).

¹¹⁹ *See* 11 U.S.C. §§ 901, 1129(a)(7)(A).

¹²⁰ *See* 11 U.S.C. §§ 901(a), 1126(c).

¹²¹ *See* Pryor, *supra* note 60, at 25–26.

¹²² *See* Fourth Amended Plan for the Adjustment of Debts of The City of Central Falls, Rhode Island at 26, *In re* City of Central Falls, R.I., No. 11-13105 (Bankr. D.R.I. July 27, 2012), available at <http://centralfallsri.us/wp-content/themes/2012CF/assets/FinancialInfo/BankruptcyPlan/FourthAmendedDisclosureStatement7-27-12.pdf>.

¹²³ Skeel, *Can Pensions Be Restructured?*, *supra* note 12, at 26.

retirees and the protections that they might enjoy under non-bankruptcy law.¹²⁴ We find both contentions unpersuasive. Current bankruptcy law does not allow a creditor to be treated favorably based on its financial circumstances, as we argue below.¹²⁵ Section III argues that non-bankruptcy protections also do not allow favorable treatment.

There is a wide gap between the priority recommended for impoverished pensioners and the legal authority to implement the recommendation. The first problem is vagueness in the Code itself. The meaning of the limitation of unfair discrimination has been seldom litigated in Chapter 9. The limitation allows a plan to discriminate against a class by treating it differently than other classes having the same priority, but prohibits the different treatment when it is “unfair” to the disfavored class.¹²⁶ Courts have attempted to supply a standard of unfairness, based on a multi-factor “test.” The most widely adopted standard looks to “(1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination.”¹²⁷ It is fairly obvious that only factor (2) states an informative standard.¹²⁸ If a plan cannot be implemented without disfavoring a class, the discrimination is necessary to implement the plan. Without an alternative plan that is otherwise preferable but does not disfavor the class, the discrimination against the class is fair. The other factors have no useable content. Discrimination that has no reasonable basis is usually irrational, arbitrary, and, therefore,

¹²⁴ *See id.* at 25 (“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 [sic] 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.”).

¹²⁵ *See* discussion *infra* Part II.

¹²⁶ *See* 11 U.S.C. §§ 901, 1129(b)(2), 1322(b)(1) (2012).

¹²⁷ *In re Leser*, 939 F.2d 669, 672 (8th Cir. 1991); *accord In re Wolff*, 22 B.R. 510, 512 (B.A.P. 9th Cir. 1982); *In re Davis*, 209 B.R. 893, 895 (Bankr. N.D. Ill. 1997).

¹²⁸ *See In re Crawford*, 324 F.3d 539, 542 (7th Cir. 2003).

unfair. For the same reason, discrimination that is unrelated to the basis for discrimination is unfair. As for (3), a plan calling for discrimination that is proposed in bad faith, just to harm the disfavored class, also is unfair.

The requirement that discrimination is unfair unless it is necessary to implement a reorganization plan is demanding. In applying the “unfair discrimination” standard to Chapter 13 plans, the requirement has been construed narrowly. The majority of courts require the plan to treat claims with the same priority equally.¹²⁹ Proposals to pay these claims different percentages therefore unfairly discriminate against disfavored claims.¹³⁰ The demand that claims with the same priority be treated equally, unless necessary to implement a plan, means that the financial circumstances of the holders of these claims cannot affect the fairness of discrimination between them. For this reason, a creditor’s poverty cannot be used to determine whether distribution favoring the creditor is fair. Similarly, a preference for lenders of student loans based on public policy does not justify giving them preferential treatment under a plan.¹³¹ Courts routinely find that Congress alone has the authority to favor certain creditors through the grant of a statutory priority.¹³² Even the minority of courts that allow fair discrimination in favor of holders of non-dischargeable debt do so based on the desirability of the debtor’s fresh start, not the financial circumstances of creditors holding this debt.¹³³

¹²⁹ See, e.g., *In re Colley*, 260 B.R. 532, 540–41 (Bankr. M.D. Fla. 2000) (“[I]f a Chapter 13 Plan provides for full contractual payments that amount to a certain percentage of the student loan creditor’s claim while providing for a lower percentage of other unsecured creditor’s claims to be paid off through pro rata distribution, then the plan discriminates unfairly under § 1322(b)(1) and may not be confirmed.”).

¹³⁰ See, e.g., *id.*; *In re Simmons*, 288 B.R. 737, 748 (Bankr. N.D. Tex. 2003).

¹³¹ See *Gorman v. Birts (In re Birts)*, No. 1:12CV427, 2012 U.S. Dist. LEXIS 107811, at *9–10 (E.D. Va. Aug. 1, 2012) (acknowledging that “there are strong policy considerations underlying the student loan program which would favor preferential treatment of student loan debt,” but stating that “[b]y not designating student loans as priority claims . . . , Congress has chosen not to categorically treat them differently”).

¹³² See *id.* at *10 .

¹³³ See *In re Tucker*, 159 B.R. 325, 329 (Bankr. D. Mont. 1993) (finding discrimination fair based on both the debtor’s fresh start and the necessity of the payment to plan implementation). Skeel may have offered a variation

Consider the plight of mass tort victims in a Chapter 11 proceeding. These creditors are at least as sympathetic as retirees. Tort victims have not consented to their injury much less the risk that the debtor will fail to compensate them. Lacking an opportunity to bargain, they did not receive compensation for the risk that they did in fact bear. The same may not be true of former government workers. Many of the retired government workers receiving pensions were once represented by a union in a collective bargaining process.¹³⁴ These unions could have bargained for greater protection of retirement benefits by demanding that the government set aside more money to fund these benefits. Some argue that government workers are paid more than their private sector counterparts, especially if one includes the benefits.¹³⁵ Perhaps this additional payment represents compensation for the risk of non-payment. A cynic might even argue that the unions intentionally avoided full

of this fresh start argument in an interview with the New York Times. *See* Walsh, *supra* note 20, at 7 (“While it would be hard to say that Detroit’s retirees fill a conventional business purpose [that would justify more favorable treatment under a plan], the city could still make valid arguments that its finances would be hurt if it cut the retirees’ benefits too drastically because it would then have to find money to support them in other ways.”). We do not find this argument convincing for several reasons. First, this fresh start justification is a minority view except in the case of debts jointly owed with co-debtors where there is an explicit statutory exception to the rule against unfair discrimination. *See* 11 U.S.C. § 1322(b)(1) (2012). Second, Chapter 9 incorporates the unfair discrimination standard from Chapter 11, not from Chapter 13 where this fresh start argument is used. 11 U.S.C. § 901. Third, unlike individuals, municipalities do not have a statutory right to a fresh start. *See* 11 U.S.C. § 1322(b)(1). Finally, a municipality would not be legally responsible to support its retirees, and many of the retirees will live outside the municipality.

¹³⁴ *See* Daniel DiSalvo, *The Trouble with Public Sector Unions*, 5 NAT’L AFFAIRS 3, 4, 7–10 (2010) (discussing the large number of public employees who receive the benefit of collective bargaining agreements).

¹³⁵ For a discussion of this controversial claim, *see* Beermann, *supra* note 99, at 18–26 (discussing the lack of clarity with respect to “whether the apparent compensation disparity between public and private sector employees is real”). Moreover, the effect may vary by level of education. Those with very high levels of education seem to earn more in the private sector while those with less education seem to earn more in the public sector. CONG. BUDGET OFFICE, *COMPARING THE COMPENSATION OF FEDERAL AND PRIVATE-SECTOR EMPLOYEES* viii (2012), available at <http://cbo.gov/sites/default/files/cbofiles/attachments/01-30-FedPay.pdf>.

funding of retirement benefits. Some academics argue that public sector unions pushed for generous benefits as a way of shrouding high compensation.¹³⁶ If the employers were required to fully fund these benefits as they accrued, the cost of the benefits would have been much more obvious. Perhaps this is why public sector unions currently argue vociferously for the use of accounting rules that minimize the apparent cost of future retirement benefits.¹³⁷

We do not argue that retirees are unsympathetic creditors in Chapter 9 bankruptcies. One can make a plausible normative argument that the claims of retirees should have priority over the claims of general creditors,¹³⁸ and we discuss some methods of giving them the priority below.¹³⁹ Our question here is whether courts properly can use the unfair discrimination standard to give them this priority. Our point is simply that, in other reorganization chapters, courts do not allow use of this standard to give priority to creditors who are at least as sympathetic.¹⁴⁰ It is therefore reasonable to conclude that the unfair discrimination standard, as applied in Chapter 9, does not allow a plan to favor retirees based on their dire financial circumstances.

It is of course possible that the standard for unfair discrimination is different, and more forgiving, in Chapter 9 than in Chapters 11, 12, or 13. But this is unlikely. For one thing, the term “unfair discrimination” is used without change or qualification elsewhere as well.¹⁴¹ Perhaps more importantly, Chapter 9 indirectly relies on the implicit standard of unfair discrimination operative in other bankruptcy chapters. This is because section 901(a) imports by reference section 1129(b)(1), which requires that the reorganization plan not unfairly discriminate against rejecting classes.¹⁴² Finally, Congress knows how to signal that different legal standards operate

¹³⁶ See, e.g., Edward L. Glaeser & Giacomo A.M. Ponzetto, *Shrouded Costs of Government: The Political Economy of State and Local Public Pensions* 48 (Nat'l Bureau of Econ. Research, Working Paper No. 18976, 2013).

¹³⁷ See generally Novy-Marx & Rauh, *supra* note 3 (discussing the estimation of the size of government pension obligations).

¹³⁸ See *In re City of Stockton, Cal.*, 486 B.R. 194, 199 (Bankr. E.D. Cal. 2013). For difficulties with this argument, see *supra* note 104.

¹³⁹ See *infra* Part II.C.

¹⁴⁰ See *supra* notes 126–35 and accompanying text.

¹⁴¹ 11 U.S.C. §§ 1129(b)(1), 1222(b)(1), 1322(b)(1) (2012).

¹⁴² See 11 U.S.C. §§ 901(a), 1129(b)(1). Chapters 12 and 13 of the Bankruptcy Code use the same “discriminate unfairly” language. 11 U.S.C. §§ 1222(b)(1), 1322(b)(1).

in different bankruptcy chapters. For example, section 1129(a)(7)'s best interest standard for impaired claims in Chapter 11 uses as a threshold the liquidation value of a distribution received in a counterfactual Chapter 7 case.¹⁴³ By comparison, section 943(b)(7) tests the best interest of creditors in Chapter 9 without reference to liquidation value, and section 901 does not incorporate section 1129(a)(7).¹⁴⁴ Accordingly, the appearance of the term “unfair discrimination” in Chapters 9, 11, and 13, without qualification, signals that the same standard of unfair discrimination operates in these Chapters. For these reasons, courts should not apply a sharply different meaning of “unfair discrimination” in Chapter 9.

The view that the standard of unfair discrimination is consistent across bankruptcy chapters works the other way as well. If courts decide to take into account the retiree's dire financial condition when applying the unfair discrimination test in Chapter 9, they should consider this factor in other chapters as well. Bankruptcy judges vetting Chapter 11 or 13 plans may find that they fairly award higher payout to sympathetic creditors such as tort victims or financially precarious suppliers in Chapter 11 or Chapter 13. While the result may have some normative appeal, it has the potential to seriously erode the equal treatment principle and leave the judicial discretion to allow a plan to favor certain creditors uncontrolled. The normative and precedential implications just noted not only suggest that the unfair discrimination limitation should not allow courts to pick and choose among creditors. They also imply that Chapter 9's unfair discrimination limitation does not allow courts to exercise this discretion.

II. State Pension Protections

Part I assumes that, at least to the extent that they are underfunded, the municipality's pension obligations are unsecured debts entitled to no priority under non-bankruptcy law. The assumption can be and has been questioned. The constitutions of a minority of states protect pension obligations.¹⁴⁵ Article I, section 24 of the Michigan constitution, for instance, provides that pension benefits are “contractual obligation[s]” that cannot be “diminished or

¹⁴³ See 11 U.S.C. § 1129(a)(7)(A)(ii).

¹⁴⁴ See 11 U.S.C. §§ 901, 943(b)(7).

¹⁴⁵ See *infra* note 152 and the accompanying text.

impaired.”¹⁴⁶ Pension obligations have priority in bankruptcy if two things are true: (1) they have priority under state law, and (2) bankruptcy law respects this priority. Whether pension obligations have priority under state law depends on the interpretation of relevant state constitutional provisions. In the Detroit bankruptcy, Judge Rhodes quickly dismissed the retirees’ argument that (1) is true, arguing that Michigan law merely granted the retirees the same rights as other contractual creditors.¹⁴⁷ Part II.A suggests that this question is at least contestable. However, this question does not matter very much because Part II.B argues that (2) likely is false: bankruptcy law displaces priorities established by state law, treating pension obligations as unsecured debt entitled to no special priority. Predominant case law and commentary assumes that only property rights give priority in bankruptcy.¹⁴⁸ Bankruptcy law does not give effect to state constitutional provisions that create priority rights not backed by property rights.¹⁴⁹ Although the assumption is reflected in case law and commentary, we are not sure that it is sound as a matter of bankruptcy policy. Property rights might be sufficient but not necessary for priority in bankruptcy. Nonetheless, notwithstanding our doubts, current bankruptcy law does not give rights priority unless they are backed by property rights created outside bankruptcy.¹⁵⁰ Part II.C describes how state governments wanting to give retirees priority effective in bankruptcy might do so.

A. Do Pensions Enjoy Priority Under State Law?

The status and priority of pension rights against state governments are a matter of state law.¹⁵¹ Seven states provide in their constitutions protections for pensions, and all take the same form.¹⁵²

¹⁴⁶ MICH. CONST. art. IX, § 24.

¹⁴⁷ See *In re City of Detroit*, Mich., No. 13-53846, 504 B.R. 97, 123 (Bankr. E.D. Mich. 2013).

¹⁴⁸ See, e.g., Skeel, *Can Pensions Be Restructured?*, *supra* note 12, at 11–12.

¹⁴⁹ See *id.* at 11.

¹⁵⁰ See *id.* at 11–12.

¹⁵¹ See *Butner v. United States*, 440 U.S. 48, 55 (1979).

¹⁵² See ALASKA CONST. art. XII, § 7; ARIZ. CONST. art. XXIX, § 1, cl. 3; HAW. CONST. art. XVI, § 2; ILL. CONST. art. XIII, § 5; LA. CONST. art. X, § 29; MICH. CONST. art. IX, § 24; N.Y. CONST. art. V, § 7. The extent of constitutional protection given to the past and future accrual of pension benefits differs among some of these states.

They deem the pension obligations of the state or its instrumentalities to be contractual obligations that cannot be “impaired or diminished.”¹⁵³ If these provisions provided retirees with protections unavailable to other creditors, it would give them a form of priority over other creditors. Priority gives a claimant a right to receive payment on its claim before another claimant receives payment on its claim.¹⁵⁴ A claim that cannot be impaired must be honored while claims that can be impaired may be modified or even annulled. Thus, a claim that could not be impaired must be paid while claims that may be impaired may not be paid (when impaired). However, this priority would not be tied to a property interest.¹⁵⁵ Although the retirees would not have a lien, their unsecured claims would be entitled to priority under state law.

Do these state constitutional provisions grant retirees a protection that other claims do not enjoy? The Contracts Clause of the federal Constitution prevents a state from impairing an obligation of contract.¹⁵⁶ Although the federal Contracts Clause limits a state’s power to impair its own contractual obligations, it does not eliminate that power. Under very limited circumstances, a state still can modify or otherwise impair these obligations.¹⁵⁷ At least according to modern Supreme Court cases, the state’s power to impair its obligations is judged by the reasonableness and necessity of the impairment.¹⁵⁸ A state can impair its obligations if doing so in the reasonable pursuit of an important public purpose.¹⁵⁹ However, less judicial deference is due the state’s decision to impair obligations when it is impairing its own contractual obligations.¹⁶⁰ The state’s self-interest in reducing its own liabilities justifies a higher standard of scrutiny.¹⁶¹ Less deference does not by itself mean that the

¹⁵³ See *supra* note 152 and accompanying text.

¹⁵⁴ 1 BANKRUPTCY LAW FUNDAMENTALS § 8:10 (“Priority means that the beneficiary of such exalted status is entitled to full payment before a penny is distributed to a claimant of lesser rank.”).

¹⁵⁵ See *In re City of Detroit*, Mich., 504 B.R. 97, 127 (Bankr. E.D. Mich. 2013).

¹⁵⁶ See U.S. CONST. art. I, § 10.

¹⁵⁷ See, e.g., *In re Jefferson Cnty.*, Ala., 474 B.R. 228, 279 (Bankr. N.D. Ala. 2012).

¹⁵⁸ See *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 241 (1978); *United States Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 22 (1977).

¹⁵⁹ *United States Trust Co. of N.Y. v. New Jersey*, 431 U.S. at 22.

¹⁶⁰ *Id.*

¹⁶¹ See *id.* at 29–31.

decision to impair its obligations never will survive judicial scrutiny.¹⁶² In *Faitoute Iron & Steel Co. v. City of Asbury Park*, the Supreme Court held that the Contracts Clause did not prohibit a state from enacting municipal insolvency legislation that allowed modification of a municipality's obligations to its unsecured bondholders.¹⁶³ *Asbury Park's* continuing force as precedent is questionable,¹⁶⁴ and even in the case the Court appeared to limit its holding to its specific facts.¹⁶⁵

Our point is simply that existing federal precedents hold open the possibility that a state could modify the rights of its municipality's contractual counterparties without violating the federal Contracts Clause. In this case, state constitutional protections might therefore provide further protection. But there is a second issue. Almost every state that has a constitutional provision prohibiting the impairment of pensions has another provision prohibiting the impairment of contracts generally.¹⁶⁶ One therefore needs an argument for why the state constitution grants greater protection to pensions than other contractual obligations such as bonds. In ruling on Detroit's bankruptcy filing, Judge Rhodes found that Michigan's constitution did not.¹⁶⁷ He found that Michigan's constitutional protection for pensions merely conferred on them the status of contracts, rejecting the old view that pensions were mere gratuitous benefits that could be changed by the state at will.¹⁶⁸ Although this is probably the correct reading of the state constitution, there is at least some room for disagreement.

Consider in this regard Michigan's constitutional protection of pension obligations. Article I, section 10 of the Michigan constitution protects all contractual obligations against impairment.¹⁶⁹ Article IX, section 24 of the state constitution

¹⁶² See generally *Faitoute Iron & Steel Co. v. City of Asbury Park*, N.J., 316 U.S. 507 (1941).

¹⁶³ *Id.* at 510–11.

¹⁶⁴ See *In re City of Detroit*, Mich., 504 B.R. 97, 100–01 (Bankr. E.D. Mich. 2013).

¹⁶⁵ See *Faitoute*, 316 U.S. at 515 (“We do not go beyond the case before us.”).

¹⁶⁶ See ALASKA CONST. art. I, § 15; ARIZ. CONST. art. II, § 25; ILL. CONST. art. I, § 16; LA. CONST. art. I, § 23; MICH. CONST. art. I, § 10.

¹⁶⁷ See *In re City of Detroit*, 504 B.R. at 127.

¹⁶⁸ See *id.* at 119–27.

¹⁶⁹ See MICH. CONST. art. I, § 10 (“No bill of attainder, ex post facto law or law impairing the obligation of contract shall be enacted.”).

separately prohibits the impairment of pension obligations as contractual obligations.¹⁷⁰ This separate treatment might signal the legislature's intention to give pension obligations additional protection against impairment not afforded to other sorts of contractual obligations. After all, if the legislature had wanted merely to protect pension obligations to the same extent that contractual obligations are protected under article I, section 10, it need only have deemed pension obligations to be contract obligations. Article I, section 10 then would have provided that protection. The fact that article IX, section 24 separately prohibits the impairment of pension obligations as contractual obligations might indicate an intention to give them additional protection against impairment by the state government. The inference to the intention to give additional protection to pension obligations is not inevitable. The separate prohibition on impairment in article IX, section 24 might simply have been a piece of uneconomical drafting. Or it could have been added out of an abundance of legislative caution to assure that pension obligations are protected to the same extent as other contractual obligations. Nonetheless, the inference from separate protection against impairment to an additional protection for pension obligations is plausible.

If pension obligations had additional protection, they would enjoy a kind of priority of payment. However, as we discuss in the next section, the priority that pension obligations have outside bankruptcy does not determine how they are prioritized in bankruptcy. Bankruptcy law instead determines the conditions under which pension obligations have priority in bankruptcy.

B. Non-Property Priority in Bankruptcy

Even if state constitutions provided protections for pensions that were not extended to other claims, bankruptcy law would not respect this effective priority unless it were tied to a property interest. Bankruptcy law does not respect all priorities established by state law, even when state constitutions provide for the type of priority described in Part II.A. If the contractual obligation is not

¹⁷⁰ *See id.* art. IX, § 24 (“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.”).

secured by a property right, it is an unsecured claim.¹⁷¹ Unless the Bankruptcy Code gives it priority, the claim is a general claim that shares in a bankruptcy distribution ratably with other unsecured claims.¹⁷² In his eligibility opinion in Detroit's bankruptcy, Judge Rhodes concludes that bankruptcy law does not respect a state constitutional provision that creates a mere contract right with priority outside bankruptcy.¹⁷³ He acknowledges that bankruptcy law would respect a constitutional provision that secures pension obligations with property rights.¹⁷⁴ However, he argues that bankruptcy law does not respect obligations that are not backed by property rights, even if state law gives them priority outside bankruptcy.¹⁷⁵ Rhodes' reasoning assumes that, without a special bankruptcy priority rule, only property rights give priority in bankruptcy.

Rhodes' assumption reflects current bankruptcy case law. It is a direct application of the basic principle announced by the Supreme Court in *Butner v. United States*.¹⁷⁶ *Butner* stands for the proposition that bankruptcy law preserves property rights, as they are defined under non-bankruptcy law, unless there is a federal interest that justifies altering them.¹⁷⁷ The Michigan constitution deems pension rights to create contractual obligations.¹⁷⁸ Contract rights are not liens, trusts, or other property rights, nor are these contract rights supported by them. Relying on the *Butner* principle, Rhodes concludes that, unless they are backed by property rights, pension obligations are not entitled to priority in bankruptcy.¹⁷⁹ Although

¹⁷¹ See 11 U.S.C. § 506 (2012).

¹⁷² See 11 U.S.C. § 507(a).

¹⁷³ See *In re City of Detroit*, Mich., 504 B.R. 97, 127 (Bankr. E.D. Mich. 2013).

¹⁷⁴ See *id.* at 126.

¹⁷⁵ See *id.*

¹⁷⁶ 440 U.S. 48 (1979). Although Congress in 1994 statutorily overruled the result in the case by amending section 552(b) (see section 552(b)(2)), it left unaffected the principle stated there.

¹⁷⁷ *Butner*, 440 U.S. at 55 ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law. Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.")

¹⁷⁸ *In re City of Detroit*, 504 B.R. at 127.

¹⁷⁹ See *id.*

supported by predominant case law, Rhodes' reasoning is not inevitable. A different conclusion might be reached without offending the *Butner* principle.

The *Butner* principle requires that bankruptcy leave property rights as defined and created under non-bankruptcy law unaltered, absent a countervailing federal interest.¹⁸⁰ Because a property right allows the holder to satisfy its claim from the asset, the property right gives the holder priority in the asset.¹⁸¹ A property right therefore is sufficient to give its holder priority.¹⁸² However, the *Butner* principle does not say that property rights are necessary for priority. As far as the principle goes, bankruptcy law might respect priority established by non-bankruptcy law, even if the priority is established without a property right. The *Butner* principle by itself therefore does not prevent the respect in bankruptcy of state priorities that are not tied to liens, trusts, or other property rights. In fact, the rationale underlying the principle argues in favor of respecting non-property based priorities in bankruptcy.

As the Court in *Butner* recognized, the principle that bankruptcy leaves property rights unaltered prevents forum shopping between bankruptcy and non-bankruptcy fora.¹⁸³ Different priorities in and out of bankruptcy encourage the wasteful investment by affected parties to put a debtor in or keep it out of bankruptcy.¹⁸⁴ As far as the discouragement of forum shopping goes, whether priority is based on property rights or on some other basis does not matter. A generalized *Butner* principle that respects non-bankruptcy priority rights even if they are not based in property better serves the rationale stated in *Butner* than the more restricted principle announced in the case.¹⁸⁵ The *Butner* principle only prevents forum shopping to take advantage of different definitions of property rights in different fora.¹⁸⁶ It allows forum shopping for favorable priority when non-bankruptcy law gives priority other than through property

¹⁸⁰ *Butner*, 440 U.S. at 55.

¹⁸¹ *See id.* at 56.

¹⁸² *See id.*

¹⁸³ *See id.* at 55.

¹⁸⁴ *See id.*

¹⁸⁵ *Id.* at 56. This generalized *Butner* principle is similar to an earlier proposal made by Charles Mooney. *See* Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 996 (2004).

¹⁸⁶ *See Butner*, 440 U.S. at 55.

rights.¹⁸⁷ The generalized *Butner* principle prevents forum shopping to take advantage of different priority rules, whether or not priority is backed by property rights. The Court in *Butner* did not need to consider the generalized version of the more restricted principle it announced there. At issue in the case was a secured creditor's entitlement to post-petition rents from its collateral.¹⁸⁸ Because the Court considered the entitlement to rents to be a property right defined by state law, it did not have to determine whether bankruptcy law must respect priorities in distribution a state sets on a basis other than property rights.¹⁸⁹ The only question for the Court was whether applicable state law gave the creditor a property right in the rents.¹⁹⁰

The generalized *Butner* principle is not a mere possibility. It was a part of bankruptcy law before 1938.¹⁹¹ Prior to the amendments to the Bankruptcy Act made by the Chandler Act, the Bankruptcy Act had a particular ordering of priority in distribution to unsecured claims.¹⁹² That ordering gave a fifth priority to persons entitled to priority by state or federal non-bankruptcy law.¹⁹³ The Chandler Act restricted this priority to those with priority under federal law as well as a limited priority for landlords for back rent under state law.¹⁹⁴ The Chandler Act cut back on the original Act's more generous priority because it was thought that respect for state law priority under the original Act left little or nothing for non-priority unsecured creditors.¹⁹⁵ The Chandler Act enhanced the importance of the difference between priorities and liens.¹⁹⁶ Liens

¹⁸⁷ *See id.*

¹⁸⁸ *Id.* at 48.

¹⁸⁹ *See id.* at 57–58.

¹⁹⁰ *Id.* at 49.

¹⁹¹ *See* STAFF OF HOUSE COMM. ON THE JUDICIARY, 74TH CONG., ANALYSIS OF H.R. 12889, at 201 (Comm. Print 1936).

¹⁹² *See id.*

¹⁹³ *See* Bankruptcy Act, ch. 541, § 64(b)(5), 30 Stat. 544, 563 (1898).

¹⁹⁴ *See* The Chandler Act, ch. 575, § 64(a)(5), 52 Stat. 840, 874 (1938) (giving priority to “debts owing to any person . . . who by the laws of the United States in [sic] entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law; *Provided, however,* that such priority for rent shall be restricted to rent . . . which accrued within three months before the date of bankruptcy”) (alteration in original).

¹⁹⁵ *See* The Chandler Act, H.R. 12889, 74th Cong. § 64(a)(5) (1936); STAFF OF HOUSE COMM. ON THE JUDICIARY, 74TH CONG., *supra* note 191, at 201.

¹⁹⁶ *See* STAFF OF HOUSE COMM. ON THE JUDICIARY, 74TH CONG., *supra* note 191, at 201.

against property were respected in bankruptcy, within certain limits.¹⁹⁷ State created priorities that did not give a right to levy on or attach property were not given effect.¹⁹⁸ It is not clear that the Chandler Act's solution solved the perceived problem. Scholars continue to complain that state property interests, especially security interests, consume too much of a debtor's estate and leave too little for general creditors, and they propose various solutions to this problem.¹⁹⁹ As we discuss more thoroughly below, the distinction between non-property priority rules and those tied to liens or some other form of property interest may not matter in the overwhelming majority of bankruptcies. The Chandler Act's change may have made a difference only for reasons of transactions costs: it may be more costly for a state to grant priority if it must support the priority by a property interest.

The generalized *Butner* principle makes no distinction between priority and liens. It would enforce all priorities in bankruptcy created under non-bankruptcy law. The only limitation is that the priority must operate generally, rather than only in bankruptcy. Consider the non-property priority rules that play a role in the state analog to a bankruptcy proceeding: an assignment for the benefit of creditors ("ABC").²⁰⁰ Some states grant priority to state

¹⁹⁷ The Bankruptcy Code allows the avoidance of some liens such as certain liens that impair exemptions, 11 U.S.C. § 522(f) (2012), liens created within the preference period, 11 U.S.C. § 547(d), and liens that constitute a fraudulent transfer, 11 U.S.C. § 548(c).

¹⁹⁸ See Bankruptcy Act § 64(b), (c); Frank R. Kennedy, *Liens and Priorities*, in *BANKRUPTCY AND THE CHAPTER PROCEEDINGS* 166 (Grace W. Holmes ed., 1976); Frank R. Kennedy, *Statutory Liens in Bankruptcy*, 39 MINN. L. REV. 697, 708 (1955); Note, *Vacation in Bankruptcy of Statutory Wage Earners' Priorities Established in Previous State Insolvency Proceedings*, 51 YALE L.J. 863, 867 (1942). Whether a statute creates a priority or a lien is not always clear. See *In re Professional Bar Co.*, 537 F.2d 339, 341 (9th Cir. 1976); *In re Leslie*, 520 F.2d 761, 762 (9th Cir. 1975).

¹⁹⁹ See English Insolvency Act, 1986, c. 45, § 175 (U.K.) (fixed percentage carve out from floating lien in favor of unsecured creditors); Lucian A. Bebchuck & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 904–05 (1996) (recommending either a fixed percentage or adjustable carve out); Elizabeth Warren, *Article 9 Set Aside for Unsecured Creditors*, 51 CONS. FIN. L.Q. REP. 323, 325–26 (1997) (recommending a fixed percentage carve out).

²⁰⁰ See Robert Richards & Nancy Ross, *Practical Issues in Assignments for the Benefit of Creditors*, 17 AM. BANKR. INST. L. REV. 5, 22 (2009) ("For

and wage claims in ways that are different than the priority that such claims would receive in bankruptcy.²⁰¹ These differences present forum shopping concerns, as creditors may push a debtor into bankruptcy because they prefer bankruptcy's priority rules to those that would apply in an ABC. The best argument against respecting these priorities is that they apply only in insolvency proceedings, and bankruptcy law often invalidates rights that arise only in insolvency.²⁰² If the concern is forum shopping, however, it is not clear why a priority that applies only in insolvency should be ignored.

We do not have to decide whether the generalized *Butner* principle is a defensible principle for bankruptcy law. Even if the principle is normatively attractive, the Bankruptcy Code and decisional law do not adopt it. Congress was aware of the place of non-property based priorities under the original Bankruptcy Act and their restriction under the Chandler Act.²⁰³ It decided not to incorporate priorities set by state law into the Code and supplied instead a set of bankruptcy priorities.²⁰⁴ A fair inference is that current bankruptcy law does not recognize non-bankruptcy priorities that are not based on property rights.

The next question is whether a different rule applies in Chapter 9. The argument for a different answer relies on section 943(b)(4) of the Bankruptcy Code. Section 943(b)(4) provides that the court shall confirm the plan if *inter alia* "the debtor is not prohibited by law from taking any action necessary to carry out the plan."²⁰⁵ The argument would be that a state law that prohibits the municipality from diminishing its pensions prohibits it from doing so in a plan. This is a weak argument, and it has been rejected by the few bankruptcy courts that have addressed it.²⁰⁶ They rightly note that state law also prohibits a municipality from

example, tax and wage claims have been recognized as priority claims in ABCs.").

²⁰¹ *See id.*

²⁰² *See* 11 U.S.C. § 545(1)(B) (2012).

²⁰³ *See* STAFF OF HOUSE COMM. ON THE JUDICIARY, 74TH CONG., *supra* note 191, at 201.

²⁰⁴ *See* 11 U.S.C. § 507(a)(1)–(10).

²⁰⁵ 11 U.S.C. § 943(b)(4). This language is a little different than the Chapter 11 analog, which requires that "[t]he plan [be] proposed in good faith and not by any means forbidden by law." *Id.* § 1129(a)(3).

²⁰⁶ *See, e.g., In re Sanitary & Improvement District No. 7*, 98 B.R. 970, 974 (Bankr. D. Neb. 1989).

impairing its contractual obligations (including to its bondholders), and such a broad reading would render Chapter 9 meaningless.²⁰⁷ Courts have also rejected a more narrow reading that would give effect to state non-property priority rules. In *In re Sanitary & Improvement District No. 7*, the bankruptcy court ultimately struck down a plan of reorganization because it did not comply with a state statute that gave bondholders priority over holders of warrants.²⁰⁸ Its reasoning, however, proves our more general point. The court did not object to the fact that the distribution under the plan failed to comply with the state priority law; even though the bondholders were not paid in full, the plan could give the warrant holders something of value.²⁰⁹ The problem was the nature of the securities given to the bondholders and the warrant holders.²¹⁰ According to the court, the problem with the plan was that the municipality could make payments on the new warrants given to holders of existing warrants even if the bonds given to the existing bondholders were called at less than par.²¹¹ In other words, the plan could not be implemented without violating state law because state law prohibited the existence of the priority scheme contemplated by the new bonds and warrants.²¹²

One might reasonably ask whether a change in bankruptcy law that would respect non-property priority rules would make any difference given the substantial freedom that states enjoy to create property interests that grant priority. There are two reasons why it might matter. First, there may be differences in transaction costs. Priority rules bound to property rights may be more cumbersome,

²⁰⁷ *See id.*

²⁰⁸ *See id.*

²⁰⁹ *See id.* (“The Court concludes that a plan may be confirmed, over objection, if it does not provide for post-petition interest even if there is an asset base sufficient to provide such interest. The reason for this is that the bondholder claims are unsecured and have no right in bankruptcy law to post-petition interest.”). The court also found that the class of bondholders voted to confirm the plan, though it did not rely on this fact in its reasoning. *Id.* at 971. A holding that section 943(a)(4) insists that the plan comply with a state law priority rule would therefore have the curious effect of making a non-property priority rule more powerful than a property based priority rule. While the latter can be waived by a class vote, an individual creditor could raise an objection based on the former.

²¹⁰ *Id.* at 974–75.

²¹¹ *See id.*

²¹² *See id.*

and therefore states may enact fewer priorities than they otherwise would want. Second, and more importantly, granting a creditor a property interest may do more than determine who has priority to the payments made by the taxpayers; it may also affect how much the taxpayers have to pay. This is not likely to be a significant issue in business bankruptcies because of the absolute priority rule, but it could be immensely important in Chapter 9.²¹³ One can imagine a scenario in which pension and other retirement obligations become so crushing that the municipality could not afford to pay them while maintaining a reasonable operating budget in full, even if bondholders and other creditors received nothing. If the retirees merely had a priority rule, a bankruptcy court could approve a plan in which the pensions were impaired. However, if state law gave the retirees a lien on all of the future tax revenue of the municipality and bankruptcy did not provide a mechanism for avoiding this lien, bankruptcy could do little to help the taxpayers. One does not need to respect non-bankruptcy law to grant a priority that is not based in property. Federal bankruptcy law can and does grant non-property based priority, and this priority could be extended to retirement benefits.²¹⁴ However, there may be good reasons to allow states to decide whether retirees deserve this priority. First, there is the old adage about states serving as laboratories of democracy.²¹⁵ Second, municipalities are themselves parts of a state, and thus we may wish to give a state greater power to decide the appropriate rule. However, these are normative arguments as to the shape of an ideal bankruptcy law, not positive arguments about the shape of existing bankruptcy law.

C. Creating Property-Based Priority for Pension Obligations

A municipality could give its workers' claims for retirement benefits priority over other claims by fully funding these benefits as

²¹³ In business bankruptcy the absolute priority rule ensures that shareholders will receive nothing unless the creditors are paid in full or consent. *See* 11 U.S.C. § 1129(b) (2012). In theory, this is true regardless of whether the creditors have a lien.

²¹⁴ For an example of the bankruptcy code granting non-property based priority, see 11 U.S.C. § 507(a)(1) (establishing priority for domestic support obligations over general creditors).

²¹⁵ *See, e.g.,* *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932).

they are earned—contributing assets to a separate fund that only the retirees can look to for payment. There may be good reasons to limit retiree priority to the amount that has been set aside to fund their pensions and other benefits. Many have argued that public sector compensation provides excessive benefits relative to salary because these costs are less salient to voters.²¹⁶ A rule that limited workers' priority to the funds that have been set aside to pay for their retirement would give them a strong incentive to ensure that the government adequately funded their pensions as they accrued and thereby made the costs of the pensions more obvious to voters. However, not everyone will agree with this approach.

A municipality could grant retirees priority without fully funding their obligations by either granting the retirees a security interest in municipal property or revenues. However, non-bankruptcy law sharply limits the municipal assets that can be pledged as collateral,²¹⁷ and bankruptcy law limits the ability of a municipality to pledge general revenues as collateral.²¹⁸ Specifically, section 552 of the Code would prevent the retiree's security interest from attaching to general revenues received by the municipality after the bankruptcy filing.²¹⁹ This limitation does not apply to special revenues derived from certain assets, such as toll revenue from a bridge,²²⁰ but a municipality's general tax revenue cannot be easily pledged as collateral or the pledge will not be effective once the municipality files for bankruptcy.²²¹ Significantly, however,

²¹⁶ See, e.g., Glaeser & Ponzetto, *supra* note 136, at 1.

²¹⁷ More accurately, non-bankruptcy law limits the ability of the secured creditor to execute on "public property" held for public use such as "streets, wharves, cemeteries, hospitals, court-houses, and other public buildings." *Meriwether v. Garrett*, 102 U.S. 472, 513 (1880). For a more thorough discussion of this issue, see ROBERT S. AMDURSKY, CLAYTON P. GILLETTE & G. ALLEN BASS, *MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE* 148–80 (2d ed. 2013).

²¹⁸ See 11 U.S.C. § 552(a).

²¹⁹ See *id.* This limitation would not apply if the new revenues were proceeds of a security interest. See 11 U.S.C. § 552(b)(1). However, this narrow exception is unlikely to be useful given the breadth of the special revenue exception discussed below.

²²⁰ See 11 U.S.C. §§ 902(2), 928(a).

²²¹ The term "special revenues" specifically excludes "receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor," 11 U.S.C. § 902(2)(E), and so a voluntary lien would be subject to section 552.

section 552 applies only to liens created by a security agreement; it does not apply to liens or other interests created by statute.²²²

This section considers more carefully the form this statutory interest may take. Our argument is simple: states enjoy substantial power to grant retirees priority through property interests, though there are some important limits on this power.

Either of two property rights can be created by legislation: a statutory lien or a statutory trust.²²³ Properly designed, both can give pension obligations priority in payment over general creditors and even secured creditors of a municipality. However, bankruptcy case law potentially limits the design of statutory liens or trusts that can give pension obligations priority.

Liens and trusts create different property rights. A lien locates title to the asset in the debtor while encumbering the asset with a charge to secure the debtor's obligation to the lienholder.²²⁴ By contrast, a trust gives the trust beneficiary ownership (equitable title) of trust assets, with the trustee retaining only legal title to them.²²⁵ In addition, a lien cannot be in an amount greater than the obligation that the lien secures. By contrast, a beneficiary of an ordinary trust is entitled to the entire value of trust assets. If the debtor owes the creditor \$100 and the debt is secured by a lien on property with a value of \$200, the creditor has a \$100 lien. If the beneficiary owns trust assets with an initial value of \$100 and the assets later increase in value to \$200, the beneficiary's trust interest is \$200.

The difference between liens and trusts diminishes in bankruptcy. With respect to priority in bankruptcy, there is no

²²² Section 552 states that "property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." 11 U.S.C. § 552(a). Because a statutory lien does not "result[] from [a] security agreement," the limitation of section 552 does not apply. *Id.*

²²³ *See, e.g.*, Perishable Agricultural Commodities Act § 5(c), 7 U.S.C. § 499e(c) (statutory trust); Federal Tax Lien Act of 1966, 26 U.S.C. §§ 6321–27 (statutory lien).

²²⁴ *See, e.g.*, 11 U.S.C. § 101(37).

²²⁵ BLACK'S LAW DICTIONARY 1647 (9th ed. 2009) (defining a "trust" as "[t]he right, enforceable solely in equity, to the beneficial enjoyment of property to which another person holds the legal title; a property interest held by one person (the *trustee*) at the request of another (the *settlor*) for the benefit of a third party (the *beneficiary*).").

difference between these property rights.²²⁶ This is because both a lien and a trust allow the entitlement holder to satisfy its interests from property before general creditors are paid from it.²²⁷ The location of title does not matter.²²⁸ A lienholder can satisfy its \$100 lien from assets subject to the lien ahead of the debtor's general creditors. The trust beneficiary who owns trust assets valued at \$100 also can "satisfy" its interest from these assets. It is paid ahead of the debtor-trustee's general creditors because it owns the assets and the debtor does not. Trust assets therefore are not property of the estate that is distributed to the debtor's general creditors. Thus, whether the debtor "owns" assets or not has no effect on the final result: whether the property right is a lien or trust, the entitlement holder is paid \$100 ahead of the debtor's general creditors.²²⁹

Nonetheless, the difference between liens and trusts does not disappear in bankruptcy. There remain some operational differences between the two sorts of property rights. The differences are consequences of the automatic stay, applicable in municipal bankruptcies.²³⁰ Because a lien leaves title with the debtor, assets subject to the lien become property of the debtor's estate. As a result, the automatic stay prohibits the lienholder from realizing on the assets or any cash flow from them without court approval. The stay, however, does not apply to trust assets. This is because the trust beneficiary owns the assets held in trust, so that its ownership does not become part of the debtor-trustee's estate (other than legal title to the assets).²³¹ Because the stay does not therefore apply to the beneficiary's ownership, the debtor-trustee's bankruptcy does not interfere with the beneficiary's access to trust assets. There are also three other aspects of relevant bankruptcy law that, taken together,

²²⁶ See *In re Magic Restaurants, Inc.*, 205 F.3d 108, 112 (3d Cir. 2000) (statutory trust created by Perishable Agricultural Commodities Act gives an unpaid supplier an interest in the trust corpus superior to liens or security interests); THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 91–92 (1986); Thomas H. Jackson, *Statutory Liens and Constructive Trusts in Bankruptcy: Undoing the Confusion*, 61 AM. BANKR. L.J. 287, 291–93 (1987).

²²⁷ JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW*, *supra* note 226, at 92.

²²⁸ *Id.*

²²⁹ See Jackson, *Statutory Liens and Constructive Trusts in Bankruptcy*, *supra* note 226, at 292.

²³⁰ See 11 U.S.C. §§ 362, 901(a) (2012).

²³¹ See 11 U.S.C. § 541(a)(1), (d).

make the difference between liens and trusts important. These aspects of bankruptcy law also constrain the way in which a statute must be drafted to guarantee the priority of pension obligations based on these property interests. One is a feature of bankruptcy case law interpretation of Bankruptcy Code provisions; the other two are features of Code provisions themselves.

1. *Characterization*: A state statute or constitutional provision could impress a trust on a municipality's assets in favor of current and retired employees in the amount of their unpaid pension obligations. Alternatively, it could provide these employees with a lien on the municipality's assets to secure the municipality's unpaid pension obligations to them. The statutory trust or lien also could give the trust or lien priority over all competing interests in the municipality's assets, including perfected security interests and other liens. Non-bankruptcy law recognizes both sorts of statutory provisions.²³² The question is whether bankruptcy law must respect statutory characterizations of the interests created as liens or trusts. The *Butner* principle requires that property rights created under non-bankruptcy law be respected in bankruptcy, unless there is countervailing federal interest for altering them.²³³ It does not require that the labels given to these property rights by non-bankruptcy law be respected in bankruptcy. Courts instead must determine the substance of these rights created by state statute or constitutional provision: are they in the nature of a lien or a trust?

Case law suggests that courts could reach different conclusions. Many courts, including the Supreme Court, treat as significant the statutory label given to the property right created.²³⁴ If the statute uses the words "trust" or "trust assets," it creates a statutory trust; if the words "lien" or "assets subject to the lien" are used, a statutory lien is created. However, other courts, sometimes including the Supreme Court, look past the statutory labels to characterize the interest created for bankruptcy purposes.²³⁵ They

²³² See, e.g., Packers and Stockyards Act, 7 U.S.C. §§ 181–229b (2012); Perishable Agricultural Commodities Act, 1930 § 5, 7 U.S.C. § 499e(c)(2) (2012); CAL. GOV'T CODE § 20574 (West 2004) (lien).

²³³ See *supra* notes 176–94 and accompanying text.

²³⁴ See *Begier v. IRS*, 596 U.S. 53, 58–62 (1990); *In re Country Club Market, Inc.*, 175 B.R. 1005, 1009 (D. Minn. 1994); *In re Frosty Morn Meats, Inc.*, 7 B.R. 988, 1005 (M.D. Tenn. 1980).

²³⁵ See *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 219–20 (1996); *Engage With Clear Vision, LLC v. Cameron (In re Cameron)*, No. 10-36921, 2011 WL 2118994, at *2 (Bankr. D. Utah May

might take into account the circumstances in which the statute gives the person the relevant interest. For instance, if the statute protects the person by a “trust” until the debtor discharges its obligations to the person, the “trust” appears to be securing these obligations. A property interest described as a “trust” also may in substance be a disguised lien if the trust beneficiary’s interest in the trust assets is limited to the amount of the obligations the debtor owes it. From this perspective, a court might conclude that a statute creating a “trust” in favor of a municipality’s employees in the amount of unpaid pension obligations owed them by the municipality in fact creates a lien.

A common feature of many statutory trusts might influence the characterization. These trusts are “floating trusts.” A floating trust impresses a trust on all of the debtor’s commingled assets, or assets of a particular type and their proceeds, without regard to whether the statutory beneficiary was the source of the assets acquired by the debtor-trustee.²³⁶ For instance, a statute might impress a trust on the excise taxes the taxpayer has collected but not paid over to the government.²³⁷ The beneficiary of this trust is the government, not the customer from whom the taxpayer collected the excise tax.²³⁸ In addition, the typical floating trust does not require that trust assets be segregated.²³⁹ This allows for the commingling of trust and non-trust assets.²⁴⁰ The allowance signals the legislative

27, 2011) (finding that an LLC statute declaring LCC member or manager a “trustee” does not create a trust; trustee status created only on member or manager’s wrongdoing). Courts have also construed statutes to create trusts based on the context in which the statute was enacted and its language. *See, e.g.,* *Duncan v. United States*, 667 F.2d 36, 41 (Ct. Cl. 1981).

²³⁶ For a description of how one “floating trust” works, see Nicole Leonard, *The Unsuspecting Fiduciary: The Curious Case of PACA and Personal Liability*, 25 AM. BANKR. INST. J. 32, 62 (2006).

²³⁷ *See, e.g., Begier*, 496 U.S. at 53; 26 U.S.C. § 7501 (2012) (“Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States.”).

²³⁸ *Begier*, 496 U.S. at 66 (identifying the “taxing authority,” or the federal government, as the beneficiary of the trust).

²³⁹ *See A&J Produce Corp. v. Bronx Overall Econ. Dev. Corp.*, 542 F.3d 54, 57–58 (2d Cir. 2008) (discussing the “non-segregated floating trust” established by the Perishable Agricultural Commodities Act).

²⁴⁰ 7 C.F.R. § 46.46 (2013) (determining that the “[c]ommingling of trust assets is contemplated” by the Perishable Agricultural Commodities Act).

intention not to require the trust beneficiary to trace trust assets in a commingled account.²⁴¹ Most courts have concluded that bankruptcy law requires tracing with respect to traditional (i.e., non-floating) trusts, whether or not the non-bankruptcy law of trusts requires tracing.²⁴² They reason that eliminating a tracing requirement violates bankruptcy law's policy of equality among creditors, who do not share in trust assets.²⁴³ Without tracing, the trust beneficiary is treated better than claimants of commingled non-trust assets.²⁴⁴

Our point here is not to criticize this reasoning. For what it is worth, we do not think that bankruptcy law adopts a policy of equality among claimants in any but the trivially true sense that like claims are to be treated alike. Bankruptcy priorities as well as bankruptcy law's respect for security interests and other liens demonstrate that bankruptcy law recognizes inequality among claimants, and bankruptcy law clearly respects floating liens created by security interests. In addition, the reasoning proves too much. A creditor with an effective floating lien has priority in assets subject to the lien.²⁴⁵ Its secured claim is not treated equally with general claims, except in the trivial sense that the secured claim has the same priority as other secured claims with the same legal character. However, our point here is different. It is that the same reasoning used by courts to require tracing might influence the characterization of the statutorily created property right. If bankruptcy policy is one of equality among creditors, a floating trust offends it. By deeming assets to be held in trust, the statute keeps them out of the debtor's bankruptcy estate. The debtor's general creditors therefore do not

²⁴¹ See *Sanzone-Palmisano Co. v. M. Seaman Enter., Inc.*, 986 F.2d 1010, 1012–13 (6th Cir. 1993); *In re Ebro Foods, Inc.*, 424 B.R. 420, 427 (Bankr. N.D. Ill. 2010).

²⁴² See, e.g., *Cunningham v. Brown*, 265 U.S. 1, 11 (1924) (requiring “tracing” to establish a constructive trust).

²⁴³ See, e.g., *id.* at 13; *In re Bullion Reserve of N. Am.*, 836 F.2d 1214, 1218 (9th Cir. 1988); *Callaway v. Memo Money Order Co.*, 381 B.R. 650, 655–56 (E.D.N.C. 2008); *Rupp v. Mayberry (In re Crocker Cos.)*, No. 2:05-CV-599 TS, 2007 WL 3333274, at *3–4 (D. Utah Nov. 8, 2007); cf. *Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co.*, 547 U.S. 651, 667 (2006) (“equal distribution objective” underlying Bankruptcy Code). For cases requiring tracing with respect to floating trusts, see *In re Dameron*, 155 F.3d 718, 722–23 (4th Cir. 1998), and *Callaway*, 381 B.R. at 655.

²⁴⁴ See *Elliot v. Bumb*, 356 F.2d 749, 754 (9th Cir. 1966) (discussing the inequities that result from not tracing).

²⁴⁵ See *Leonard*, *supra* note 236, at 62.

share in trust assets; they must satisfy their claims from assets that remain in the debtor's bankruptcy estate. Equality therefore might be a reason for characterizing the interest created by a statute as a "lien," not a "trust." A lien attaches only to the assets described by the statute, which remain the debtor's property, not to other assets commingled with them. Although the lienholder still has priority in assets subject to the lien, it does not have priority in the other assets. In this way the lien characterization produces less inequality among those with claims against the debtor.

Nothing in the nature of a trust prevents a statute from settling a trust on a municipality's assets in favor of pensioners to the extent of its unpaid pension obligations.²⁴⁶ Even if a trust requires an identifiable corpus, that corpus need not be contributed by the settlor or even the beneficiary. It is enough that the statute defines specific assets as trust assets. The typical statute creating a floating trust settles a trust on assets the beneficiary has supplied to another.²⁴⁷ However, because these statutes allow the commingling of trust and non-trust assets, the trust beneficiary is not required to trace trust assets.²⁴⁸ This effectively allows trust assets to include assets not contributed by the trust beneficiary. The trust corpus therefore extends to commingled assets not contributed. It nonetheless remains identifiable. In fact, statutes can settle a trust on assets even without a contribution by the beneficiaries of the trust. For example, Internal Revenue Code section 7501 settles a trust in favor of the government in the amount of employee taxes withheld by the employer but not paid over to the government.²⁴⁹ The Supreme Court considers this

²⁴⁶ See UNIFORM TRUST CODE § 102 (2000) ("This [Code] applies to . . . trusts created pursuant to a statute . . .").

²⁴⁷ See, e.g., Packers and Stockyards Act of 1921, 7 U.S.C. §§ 181–229(b) (2012); Perishable Agricultural Commodities Act, 7 U.S.C. § 499e(c)(2).

²⁴⁸ See *Sanzone-Palmisano Co. v. M. Seaman Enter., Inc.*, 986 F.2d 1010, 1012–13 (6th Cir. 1993); *In re Ebro Foods, Inc.*, 424 B.R. 420, 427 (Bankr. N.D. Ill. 2010). Although a trustee has a fiduciary duty not to commingle trust and personal assets, the duty is a default rule only; it can be varied by statute. See UNIFORM TRUST CODE § 105(b) (prohibition against commingling not among enumerated mandatory rules); UNIFORM TRUST CODE § 810(b) (duty of trustee to keep separate trust and personal assets).

²⁴⁹ See 26 U.S.C. § 7501 (2012) ("Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States.").

provision to create a trust even without an identifiable trust corpus.²⁵⁰ If a statute can settle a trust without an identifiable corpus, it can settle one with assets that the trust beneficiary does not contribute. Such a statute still satisfies the traditional requirement that the trust corpus be identifiable. For the same reason, a statute that impresses a trust on the municipality's assets for the benefit of unpaid pension obligations is not inconsistent with the legal character of a trust. Whether such a statute in fact creates a trust or a lien is a further question.

2. *Avoidance*: The character of a property right as a lien or trust affects the bankruptcy trustee's power to avoid these interests. These avoidance powers differ according to whether a statutory lien or statutory trust is created. The bankruptcy trustee can avoid a statutory lien that first becomes effective only on the debtor's insolvency or bankruptcy.²⁵¹ The lien also is avoidable if it is unperfected and unenforceable against a hypothetical bona fide purchaser of property subject to the lien.²⁵² An unavoidable statutory lien cannot be avoided as a preference, even if the lien arises within the preference period and is otherwise a preference.²⁵³ By contrast, the trustee must use its strong-arm powers to avoid a statutory trust. These powers differ according to whether trust assets are in personal or real property.²⁵⁴ If trust assets are personalty, the trustee has rights and powers of avoidance of a hypothetical lien creditor. These powers generally are more limited than the rights non-bankruptcy law gives a bona fide purchaser of real property. Thus, a trustee, relying on a lien creditor's rights, might not be able to avoid a statutory trust in personal property while, relying on a bona fide purchaser's rights, it could avoid a statutory lien in the same property. A statutory trust generally is not avoidable as a preference, because trust assets are not property of the debtor-trustee.²⁵⁵ Thus, a transfer of these assets, even on account of an antecedent debt, cannot be a preference. However, a statutory trust impressed on the debtor's assets within the preference period can constitute a preference, if the other preference conditions are met.

²⁵⁰ See *Begier v. IRS*, 496 U.S. 53, 54 (1990).

²⁵¹ See 11 U.S.C. § 545(1).

²⁵² See 11 U.S.C. § 545(1)–(2).

²⁵³ See 11 U.S.C. § 547(c)(6).

²⁵⁴ See 11 U.S.C. § 544(a)(1), (3).

²⁵⁵ See 11 U.S.C. § 547(b) (“transfer of an interest of the debtor in property”).

The risk of avoidance is insignificant whether pension obligations are supported by a properly designed statutory trust or statutory lien. This is because the trust or lien created can be insulated from avoidance, however a court decides to characterize the interest. If the court decides that the beneficiary's interest is a lien and the interest is unperfected, the court could appoint a trustee to avoid the interest.²⁵⁶ However, to protect against avoidance, a statute ostensibly creating a statutory trust can simply require the trust beneficiary to perfect its beneficial interest in a prescribed manner. In that case, the court cannot avoid the interest should the court decide that the interest in fact is a lien.²⁵⁷ For the same reason, the statute can impress a trust on the debtor's assets without regard to the debtor's financial condition or insolvency. If the beneficiary's interest turns out to be a lien, the provision assures that the lien is unavoidable. Even if a court decides that the statute creates a trust, a trust impressed without regard to financial condition or insolvency leaves the debtor-trustee with no interest in trust assets (other than legal title to them). As a result, the debtor's transfer of trust assets to beneficiaries within the preference period is not a preference.

3. *Priorities*: Statutory trusts and liens often expressly order priorities between trust beneficiaries or lienholders and third parties. Some give priority to the beneficiaries or lienholders even against prior perfected security interests. A statutory trust or lien that gives priority to certain unsecured creditors, such as wage claimants, while politically attractive, creates a risk that the trust or lien is avoidable in the debtor's bankruptcy. This risk is the result of the rule of *Moore v. Bay*.²⁵⁸ The rule allows the debtor's bankruptcy trustee to use the rights of an actual unsecured creditor under non-bankruptcy law to avoid a transfer in its entirety.²⁵⁹ *Moore v. Bay*'s rule applies only if non-bankruptcy law gives the actual unsecured creditor the right to set aside the transfer.²⁶⁰ Although state fraudulent transfer law is the most frequently used non-bankruptcy law trustees rely on, it might

²⁵⁶ See 11 U.S.C. §§ 544(a)(1), 544(a)(3), 926.

²⁵⁷ Cf. 7 U.S.C. § 499e(c)(3)–(4) (notice requirement under Perishable Agricultural Commodities Act).

²⁵⁸ 284 U.S. 4 (1931).

²⁵⁹ See 11 U.S.C. § 544(b)(1).

²⁶⁰ See *id.* (applying only to transfers that are voidable under applicable law).

not be the only law available. Statutory trusts or liens that give an unsecured creditor priority potentially are applicable too.²⁶¹

Whether *Moore v. Bay*'s rule can operate on them depends on the interpretation of the priority recognized by the relevant statutory trust or lien. If the priority merely gives an unsecured creditor the right to be paid first, the unsecured creditor does not have the right to avoid the transfer. In this case, the trustee cannot use the claim of an actual unsecured creditor with the priority to avoid the transfer. If priority is construed to give the unsecured creditor a right to be paid first by setting aside trust or lien interests, priority gives the creditor a right of avoidance. *Moore v. Bay* allows the trustee to avoid the trust or lien. Thus, giving priority to certain unsecured creditors puts a statutory trust or lien at risk in the debtor's bankruptcy. The easiest way of avoiding this interpretive problem of course is not to create this priority or to clearly signal that priority does not give a power of avoidance. A properly designed statutory lien or trust supporting a municipality's pension obligations can do this.

III. Conclusion

Most of this paper is devoted to a positive claim: current law does not allow a bankruptcy judge to grant pensions priority if the other claimants object. However, we conclude with a few normative thoughts. Many find that, as a moral matter, pensions should have priority in bankruptcy. Existing bankruptcy law may be used or revised to give pensions priority in payment. To protect pensions, states could support them with statutory liens or trust interests that would be respected in bankruptcy. However, these liens or trusts might interfere with the municipality's reorganization. This is because property interests may do more than merely grant priority in the conflict between creditors; they may also affect the outcome of the conflict between citizens and creditors over the municipality's assets. A plan that reduced payments to unsecured obligations to zero may not provide a municipality in significant financial distress with enough relief. The municipality may be left with insufficient unencumbered assets or revenue sources to provide adequate services to its citizens. In these circumstances, a lien or trust could

²⁶¹ Cf. CAL. GOV'T CODE § 20574 (West 2004) (state's statutory lien on terminated contractor's assets allows assets to be available to recover costs of collecting of the lien).

prevent an adjustment of pensions (or bonds) that is necessary for the municipality to continue operating at tolerable levels of taxation and spending.

Other approaches require a change in bankruptcy law. One approach would be to provide pensions priority status with the priority the Bankruptcy Code currently gives to certain other sorts of unsecured claims.²⁶² This approach has its own problems. A federal bankruptcy-specific priority imposes a procrustean solution on all states. States can differ with respect to their central and local fiscal conditions, as well as in the extent to which they regulate pension obligations incurred by their municipalities. There is no reason to believe that a uniform rule giving pensions priority would suit all states or their taxpayers. Such a rule would force some states to allocate the direct and indirect costs of a municipal bankruptcy in a way they would not prefer. In addition, this approach would require a fairly fundamental change in the Bankruptcy Code before it would allow the adjustment of priority debts. Rather than merely considering the status of priority claims in the absolute priority rule, the Bankruptcy Code's reorganization chapters insist that these claims be paid in full.²⁶³

History suggests two other ways in which existing bankruptcy law could be changed. One proposal would amend the Bankruptcy Code to give the trustee in Chapter 9 the power to avoid liens that impair a municipality's ability to continue with acceptable levels of taxation and services. Statutory liens that support pension obligations would remain unaffected to the extent that their avoidance is unnecessary to maintain the municipality's economic viability. There is precedent of sorts for the statutory change. The Bankruptcy Act gave the trustee broader powers to avoid certain statutory liens than the Bankruptcy Code gives it.²⁶⁴ Similarly, the Bankruptcy Code allows the individual debtor to avoid certain liens

²⁶² See 11 U.S.C. § 507.

²⁶³ See 11 U.S.C. §§ 1222(a)(2), 1322(a)(2). Chapter 11 is a little more complicated as it requires the full payment of all priority claims except unsecured claims arising out of commitments to the FDIC and claims for death or personal injury from drunk driving. 11 U.S.C. § 1129(a)(9).

²⁶⁴ See Bankruptcy Act of 1898, ch. 541, § 67(c), 30 Stat. 544, 564 ("A lien . . . which was begun against a person within four months before the filing of a petition in bankruptcy . . . shall be dissolved by the adjudication of such person to be bankrupt . . ."); *cf.* 11 U.S.C. § 545(1)–(2) (laying out the ways in which a trustee can avoid statutory liens).

that impair its exemptions.²⁶⁵ A power to avoid liens to maintain the municipality's economic viability also has its problems. The proposal gives the municipality, acting in the capacity of the trustee, an enormous amount of discretion. Although the bankruptcy court oversees the trustee's exercise of its avoidance power, within broad limits the power would inevitably leave to the municipality the judgment as to the acceptable levels of taxation and services. In addition, states may want to make binding commitments, and a Bankruptcy Code that allows municipalities to avoid liens *ex post* limits their ability to do so. As an alternative, Congress could amend the Code to respect non-property priorities created by non-bankruptcy law. Until 1938, federal bankruptcy law respected state law priorities even if these priorities were not linked to property interests.²⁶⁶ Although Congress later explicitly rejected this approach,²⁶⁷ perhaps it was wrong to do so. Respect for non-property based state law priorities in Chapter 9 at least deserves another hearing.

²⁶⁵ See 11 U.S.C. § 522(f).

²⁶⁶ Bankruptcy Act, ch. 541, § 64(b)(5), 30 Stat. 544, 563 (1898).

²⁶⁷ The Chandler Act, ch. 575, § 64(a)(5), 52 Stat. 840, 874 (1938).