What Happens to Public Employee Retirement Benefits When Municipalities Go Bankrupt?

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In Brief

When municipalities go bankrupt, subsequent debt negotiations with creditors may place public employee pension and non-pension retirement benefits at risk. This brief outlines the benefits at risk and the emerging case law from the municipal bankruptcies in Stockton, California; Detroit, Michigan; and Central Falls, Rhode Island.

Introduction

Municipalities typically promise their public employees benefits upon retirement, including pension, health, and welfare benefits. Under normal operations, contract law generally guarantees these benefits for retirees. In some cases, state constitutional law provides additional protections. However, when municipalities go bankrupt, the ensuing debt negotiations with creditors may compromise the funds meant to pay retirees those benefits. Such negotiations can result in the redirection of those funds toward creditors. This explains why in the most recent prominent bankruptcy cases, public employee retirement benefits have been at the center of a conflict between established legal protections and federally governed bankruptcy decisions.

Further complicating debt negotiations are competing interests among a municipality's creditors. When deciding which debts to pay, reduce, or eliminate altogether, the municipality must navigate a series of potential negative consequences.

Recent municipal bankruptcies have provided new insights into what actually happens to retiree benefits after a bankruptcy filing. Here, we review how municipal bankruptcies work and the types of public employee benefits at stake. We also review how three municipal bankruptcies have established precedents surrounding the role of public employee retirement benefits in bankruptcy proceedings.

Background: Chapter 9 Municipal Bankruptcy and Debt Negotiations

When **municipalities** (cities, towns, counties, taxing districts, municipal utilities, and school districts) cannot pay their debts, they may be eligible for a specific type of bankruptcy proceeding known as **Chapter 9**. Chapter 9 provides for the appointment of a federal bankruptcy judge to oversee **debt negotiations** between municipalities and their stakeholders, which typically include **municipal bondholders** and **retired public employees**. Given the already limited financial resources of municipalities that file for Chapter 9, debt negotiations may pit individual stakeholders against one another, and municipalities face difficult decisions regarding which debts to pay, reduce, or eliminate. After a municipality has completed debt negotiations, it creates a final plan to resolve debts and return to solvency, which it articulates in a document known as a **bankruptcy exit plan.**

Each type of debt reduction a municipality may choose has negative consequences. **Defaulting on municipal bondholders** damages a municipality's bond rating and ability to borrow in the future. For this reason, municipalities or states sometimes legislatively bind municipalities to prioritize bond repayment over other types of debts. **Cutting retirement liabilities** to active and/or retired public employees leaves those retirees without promised benefits, even as many remain ineligible for federal Social Security benefits due to having public pensions. Furthermore, cutting promised pensions or other benefits can encourage current public employees to abandon their positions and move to the private sector.

Public Employee Retirement Benefits and Their Special Protections

Two types of employee retirement benefit debts are generally at stake in bankruptcy negotiations:

- **Pensions** are regular payments to an employee upon retirement. Pensions are contractual obligations protected by contract law, robust federal statutes, and in some cases, special provisions within state constitutions.
- **Other Post-Employment Benefits (OPEBs)** are non-pension retirement benefits, such as life insurance, healthcare, welfare, and deferred-compensation benefits. While OPEBs are also contractual obligations, they are not as universally or clearly protected as pensions.

Without a Road Map: Case-by-Case Decisions

Given the multiple competing interests and legal ambiguities in municipal bankruptcies, we reviewed three cases and researched the factors that appeared to influence municipalities' decisions about retirement benefit debts. In all three cases, state constitutional law protected retirement benefits, but each federal judge declared that all debts were negotiable under federal bankruptcy law. We identified these factors at play in each case:

1) **Size of the bankruptcy and unfunded retirement benefit liability:** Is the municipality capable of paying down the unfunded portion of its retirement benefit liability?
2) **Legal obligations to prioritize bondholders over public employees:** Is the municipality legally obligated to prioritize payments to certain stakeholders over others?
3) **Attitudes toward public employee obligations:** Is the municipality willing to risk potentially undermining its relationships with public employees and retirees?

Below, we take a closer look at three high-profile municipal bankruptcies – Stockton (2012), Central Falls (2011), and Detroit (2013) – and analyze these factors and their roles in each case.

Stockton, California: Pensions at Risk but Not Cut in Bankruptcy Negotiations

The city of Stockton filed for Chapter 9 bankruptcy in 2012, placing $41.3 million in unfunded pension liabilities and nearly $550 million in unfunded OPEB obligations at stake in debt negotiations. The California Public Employees' Retirement System (CalPERS) defended these obligations, arguing that the state constitution guaranteed both pension and OPEB obligations. In the face of CalPERS' arguments, federal bankruptcy Judge Christopher Klein ruled that Stockton could indeed cut pension and OPEBs in its bankruptcy exit plan. Klein argued that federal bankruptcy law impairs contracts and supersedes state constitutional obligations. Following this ruling, it seemed pension obligations, once thought to be legally sacrosanct in California, could be cut under bankruptcy. Klein's ruling was the first of its kind in California and may have implications in future cases.

Although Stockton had the option to cut pension obligations, the city's attitudes toward public employees played a strong role in maintaining pension and OPEB benefit levels as much as possible. Both Stockton's city manager and city council cited concerns that cuts would cause public employees to leave the city's employment. Consequently, the city's final bankruptcy exit plan maintained its pension obligations. However, the city distinguished between protections for pensions and OPEBs, cutting the $550 million in OPEB obligations entirely.

Central Falls, Rhode Island: Pension Cuts in Action

Central Falls declared bankruptcy in 2011. At that time, the small municipality of less than 20,000 people owed $20.1 million to general obligation bondholders and $80 million in pension and OPEB debt to 214 retired police officers and firefighters. In Central Falls, both the size of the retiree benefit debt and obligations under state law drove the city's decision to cut retiree benefits.

Seeking to protect municipalities from credit downgrades, the Rhode Island General Assembly passed a law in 2010 requiring municipalities to prioritize bondholder claims over other obligations in bankruptcy negotiations. Thus, the city was unable to negotiate bondholder debt and it ultimately approved a bankruptcy exit plan with reductions of up to 55% for pension payments and healthcare benefits for retired police and firefighters.

Detroit, Michigan: Record-Breaking Bankruptcy and Cuts for Pensioners

In 2013, Detroit filed for the largest municipal bankruptcy on record, owing $18 billion primarily to general obligation bondholders and retirees. Michigan's constitution, like California's, prohibits any reductions to pensions or other retirement benefits. Again, despite the state protections, Detroit's federal bankruptcy judge approved cuts to pensions and retiree healthcare obligations. In both the Stockton and Detroit cases, federal bankruptcy law superseded state constitutional protections, and both pension and benefit obligations were up for negotiation.

In Detroit, the sheer size of the city's bankruptcy and pension debt seemed to force the hand of city planners. From the outset, Detroit's bankruptcy manager reportedly recognized it would have to shave its debts on every front, including city retiree benefits. The bankruptcy exit plan required retired city workers to return some funds to the city, asserting that they had been overpaid on interest. Additionally, the city reduced retirees' pensions by 4.5%. In addition to the direct pension reductions, the city reduced health benefits by over $3.8 billion.

Summary

- When municipalities declare Chapter 9 bankruptcy, a federal judge oversees debt negotiations with their creditors to resolve debts.
- In developing a bankruptcy exit plan, municipalities must weigh the consequences of cutting their debts to creditors. The size of the bankruptcy and retirement benefit debt, legal constraints, and political risks relating to public employees and citizen responses are factors at play in municipalities' final plans to resolve their debt.
- In Central Falls, RI (2011), Stockton, CA (2012), and Detroit, MI (2013), federal bankruptcy judges consistently agreed that pension and OPEB obligations could be cut, even in cases where state constitutions protected these benefits. In Detroit and Central Falls, bankruptcy exit plans ultimately cut pension benefits to current employees and retirees. All bankruptcy exit plans included cuts to OPEBs, namely healthcare.

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