UT LAW CLE THE UNIVERSITY OF TEXAS SCHOOL OF LAW

PRESENTED AT

35th Annual Jay L. Westbrook Bankruptcy Conference

November 17-18, 2016
Austin, Texas

How City Finances Can Be Restructured: Learning from Both Bankruptcy and Contract Impairment Cases

by
Zack A. Clement
and
R. Andrew Black

How City Finances Can Be Restructured: Learning from Both Bankruptcy and Contract Impairment Cases

by

Zack A. Clement

and

*R. Andrew Black**

*Zack A. Clement is a Partner, and R. Andrew Black is Senior Counsel, at the Houston, Texas office of Fulbright & Jaworski LLP, part of Norton Rose Fulbright. The view's expressed in this article are those of its authors, not of their law firm or its clients.

I. INTRODUCTION

Detroit, Michigan is the largest city to file a chapter 9 bankruptcy case to date, but there are many other municipalities with the same fundamental problem—a combination of massive labor, pension, and bond obligations that render them insolvent. This article discusses the state and federal law available to help these cities return to solvency.

Since World War II, U.S. cities have promised to pay employees billions of dollars in the future for supplying labor in the present.[1] In 2010, the gap between states' assets and their obligations for public sector retirement benefits was $1.38 trillion, up nearly 9% from fiscal year 2009. Of that figure, $757 billion was for pension promises and $627 billion was for retiree health care.[2] Instead of funding these promises with tax revenue as the obligations

---

[1] *The Widening Gap Update*, THE PEW CHARITABLE TRUSTS, 1 (June 2012) *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Pensions_Update.pdf (last visited Dec. 18, 2013) [hereinafter, the *Pew Widening Gap Update*]; *see also The Trillion Dollar Gap: Unfunded State Retirement Systems and the Roads to Reform*, THE PEW CHARITABLE TRUSTS 17 (Feb. 2010) *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2010/Trillion_Dollar_Gap_Underfunded_State_Retirement_Systems_and_the_Roads_to_Reform.pdf (last visited Dec. 18, 2013).

[2] States and municipalities have often promised increased employee benefits while failing to make the contributions necessary to fund these promises. Pew Widening Gap Update, *supra* note 2, at 1. These figures represent the liabilities of state, and local governments participating in state-wide, retirement systems. Another study focused solely on municipal employee benefit funding found that:

> 61 key cities across America—the most populous one in each state plus all others with more than 500,000 people—emerged [from the Great Recession] with a gap of more than $217 billion between what they had promised their workers in pensions and retiree health care and what they had saved to pay that bill.

A Widening Gap in the Cities, THE PEW CHARITABLE TRUSTS 2 (Jan. 2013) *available at* accrued, many cities borrowed from the capital markets to fund them. Total outstanding municipal bond debt in the United States for all purposes, including pensions, has grown from less than $20 billion in 1945 to over $3.7 trillion today.[3]

Layered on top of this substantial debt to providers of capital and labor, the near collapse of the financial system in 2008, and the slow pace of recovery since then, has placed enormous strains on the budgets of many municipal governments.[4] While tax revenues have stabilized somewhat from the Great Recession, in most cases they have not returned to previous levels.[5]

Many cities have addressed these challenges by reducing services, cutting payroll, and deferring maintenance to try to balance their budgets.[6] Nearly every state has reduced public pension benefits or increased employee contributions in the last four years.[7] Public employees depend on these wages and benefits. Bondholders expect a city to pay back what it has borrowed. But there are limits to a city's ability to cut services and raise taxes. If a city cuts services too much, or if citizens are taxed beyond their capacity, city residents who are able to pay taxes will have an incentive to move to lower tax, higher service suburbs, triggering a depopulating "death spiral" in that city.

The law offers cities two sources of power to overcome municipal insolvency. First, state "police power" permits a municipality to alter existing contract rights if doing so serves a public purpose and stops short of unconstitutionally impairing those rights. Second, chapter 9 of the Bankruptcy Code[8] gives a municipality the power to reject contracts and to fundamentally restructure its obligations to labor and capital suppliers.

Financial restructuring conducted outside of bankruptcy often focuses on reducing services and cutting public employees' wages and benefits. However, the exercise of police power to modify labor-related contracts is constrained by constitutional protections against the impairment of contracts[9] and, even if available, is only a partial solution.

Federal municipal bankruptcy law permits an insolvent city to engage in a

---

www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_city_pensions_report.pdf (last visited Dec. 18, 2013).

[3]The State of the Municipal Securities Market, www.sec.gov/spotlight/municipalsecurities.shtml (last visited Dec. 18, 2013).

[4]*See, e.g.*, MARK MAURO & CHRISTOPHER W. HOENE, BROOKINGS INSTITUTION, Fiscal Challenges Facing Cities: Implications for Recovery (2009).

[5]Pew Widening Gap Update, *supra* note 2, at 4.

[6]*See, e.g.*, CHRISTOPHER W. HOENE & MICHAEL A. PAGANO, NATIONAL LEAGUE OF CITIES, Research Brief on America's Cities 26 (2011).

[7]Pew Widening Gap Update, *supra* note 2, at 8-9.

[8]11 U.S.C. §§ 901-946. References to "Section" or "§," unless otherwise noted, hereinafter refer to title 11 of the United States Code (the "Bankruptcy Code").

[9]*See, e.g.,* U.S. CONST. art. I, § 10.