Facing Up to America’s Pension Woes

By David Skeel

Right after Detroit filed for bankruptcy under federal law last week, Michigan’s Ingham County Circuit Judge Rosemarie Aquilina issued a set of rulings that attempted to stop the process cold—she worried that a bankruptcy would restructure Detroit city workers’ pensions in violation of the state constitution. Few expect her rulings to stand—a violation of the state constitution.

They concluded that any reduced pension costs wouldn’t be great enough to offset the legal costs and backed off.

Since Vallejo, the pension question has become increasingly hard to avoid. When Central Falls, R.I., filed for bankruptcy in 2011, the small town made it clear that significant pension cuts were its only hope for recovery. In the end, Central Falls reduced its pension costs by 50%. Because the town’s retirees reluctantly agreed to the cuts, the bankruptcy court didn’t address the legal question of whether Chapter 9 allows a city to reduce its pension obligations.

Steven Rhodes, the federal bankruptcy judge assigned to Detroit, won’t have this luxury. The status of pension obligations also is at issue in the bankruptcies of Stockton and San Bernardino, both in California. It is possible that Judge Rhodes will have the benefit of rulings in one or both cases when he rules in Detroit. But Stockton, no doubt mindful of the Vallejo experience, is trying to duff the pension issue. There also are signs that San Bernardino could do the same.

Detroit isn’t ducking. Emergency manager Kevyn Orr has signaled that every constituency needs to sacrifice. And Detroit’s public workers aren’t yielding an inch.

Article IX, Section 24, of the Michigan state constitution says: “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.” Yet Chapter 9 of federal bankruptcy law clearly authorizes a city to restructure its obligations to restore financial health.

How will the conflict be resolved? Chapter 9 should prevail. The U.S. Constitution (Article VI) states that the United States is “the supreme law of the land,” and furthermore, that judges in every state are bound by them, “anything in the constitution or laws of any state to the contrary notwithstanding.” This doesn’t mean that Detroit workers could be left with nothing. As of June 30, 2012, the assets held in trust for Detroit’s general retirement system benefits were valued at $2.16 billion. These funds are property of the retirees, much as the collateral a borrower puts up to secure a loan belongs to the lender. It is only the unfunded portion of the pensions ($830 million by Detroit’s estimate, $2 billion by Mr. Orr’s, plus his estimate of another $1.4 billion in underfunding for the police and firefighters’ pensions) that is subject to restructuring.

There are two possible objections to this reasoning. The first is that giving the retirees anything less than the full amount of their promised benefits would violate the U.S. Constitution’s Fifth Amendment, which prohibits the taking of private property without just compensation.

The pension funds can argue that any adjustment would violate pensioners’ investment-backed expectations. But this argument will likely fail. Property rights are ordinarily protected only up to the value of the property set aside. This logic has always applied with corporate pensions.

The second objection goes to the heart of Chapter 9 itself. The U.S. Constitution prohibits a state from impairing the obligation of contracts (Article I, Section 10). Thus Michigan itself could not alter the rules for existing retirees, even if it changed its constitution to remove the protection of pension benefits. Any change would only affect new pensions. And so, current retirees could argue, if Chapter 9 is interpreted to allow pension restructuring, this seems to enable Michigan to violate the U.S. Constitution.

A very similar argument, along with a related argument about state sovereignty, led the Supreme Court to strike down the first municipal bankruptcy law passed by Congress in 1936. But two years later, in United States v. Bekins, the court reversed course, concluding that a slightly amended bankruptcy law didn’t violate the Contracts Clause or interfere with state sovereignty.

Detroit’s pensioners, in short, would ultimately prevail only if they could persuade the Supreme Court to overturn Bekins—which would in effect invent a federal municipal bankruptcy law altogether, since the same logic would apply not just to pensions but to any obligation protected under state law.

It is unlikely the Supreme Court would take this step. The court has interpreted Congress’s bankruptcy powers (which also are spelled out in the Constitution) very broadly. And the power to facilitate the adjustment of debt lies at the heart of bankruptcy.

None of this means that pensions can or should be reduced to the maximum extent possible. They shouldn’t. The pensions for Detroit’s city workers don’t appear to be extravagant, and the bankruptcy judge ought to be mindful of the very real effects on the lives of retirees when he decides whether to approve any reduction in benefits.

Chapter 9 requires that a restructuring of obligations be in the best interests of creditors—including the retirees. This suggests that sacrifice must be shared among all of a city’s general creditors, bondholders as well as public employees.

As the pension issue goes, so goes Chapter 9. If Detroit can make at least modest adjustments to its pensions, and restructure its other obligations as well, the city and other municipalities in dire financial straits may have a fighting chance. If not, the downward financial spiral of too many American cities is likely to continue.