Stockton, California: Bankruptcy judge poised to rule against workers

Kevin Kearney
12 December 2012

After dismissing a petition brought by Stockton retirees to save their health care benefits last August, Federal Bankruptcy Judge Christopher M. Klein will soon rule on a petition by bond insurers which, if granted, will require Stockton to slash pension obligations of retired and current city workers to the bone before it can proceed to bankruptcy. The decision would facilitate bipartisan efforts to impose the burden of the economic crisis on the working class. It would open a new avenue of attack in which the courts would nullify the legal obligations of municipalities to public employees.

Judge Klein's decision flows from the risks municipal bankruptcies present to bank profits. In 2008, the city of Vallejo became the largest city to declare bankruptcy. At 117,000 people Vallejo dwarfed earlier municipal bankruptcies, usually filed by cities of less than 25,000. Bankers and politicians were deeply concerned that such a precedent could be followed by other major cities thereby allowing them to default on debt owed to big banks and their wealthy investors.

The operating budget of every level of government from the smallest city to the state itself depends on reliable and affordable financing from big banks through bonds, which are extended to the governmental entity in exchange for regular interest payments which rise and fall with the perceived "creditworthiness" of the governmental entity. Any perceived risk to a bank or bond insurer's shareholders can trigger an increase in interest payments, higher deficits, and ultimately, the further destruction of social programs essential to masses of people. In other words, the investment income of the rich trumps all other concerns, no matter how sacred.

Since the economic collapse of 2008, government is more beholden to finance capital than ever because many of its major sources of tax income have dissipated or disappeared.

Following Vallejo's bankruptcy, the crisis deepened and several major California cities, dwarfing Vallejo, began to seriously consider bankruptcy themselves. The state legislature reacted by passing a new law adding an additional hurdle to the bankruptcy process to ensure that cities would make the deepest cuts possible before defaulting on bank-held debt. During the mandated mediation process, Stockton did just this by teaming up with public employee unions to force $90 million in wages and benefits cuts on Stockton workers.

To top it off, Stockton unilaterally stole an additional $20 million from the workers before it cut off retirees' health care altogether as part of the mediation process. The tragic impact of these cuts was forcefully demonstrated when retired workers packed a city council meeting in June to register their opposition. The scene made it clear to all present that a huge section of the city's most vulnerable workers were being thrown out like garbage. One story, in particular, moved the entire room to tears: a former city police officer who had contracted brain cancer explained in a wavering voice that cutting off his medication was like a death sentence.

Despite this social butchery, the city was still insolvent after the "mediation" period was over, and allowed to proceed to bankruptcy. Stockton remains the largest municipal bankruptcy and a critical new front in the ruling class assault on workers. (In re City of Stockton, No. 12-32118 (Bankr. E.D. Cal. filed June 29, 2012).).

Shortly after Stockton filed its bankruptcy petition, an association of retired city workers requested a temporary restraining order and/or permission from Judge Klein to challenge the elimination of their health

benefits as unconstitutional, alleging the cuts were a violation of the contract clause—of both the state and federal constitutions—since the workers had gained the benefits as part of a labor contract which they had honored with their life's work.

In August, Judge Klein dismissed the worker's request, stating that section 904 of the Bankruptcy Code "forbids the court from using any of its powers to 'interfere with' property or revenues of a chapter 9 debtor." As for the fact the workers—who had worked for the city in exchange for certain wages and benefits that generally ensured no more than their basic needs—Judge Klein continued, "…although the city's unilateral interim reduction of retiree health benefit payments may lead to tragic hardships for individuals…the motion for injunctive relief must be denied."

The court's absolute indifference to the "tragic hardships" of retired workers is not just revolting, it has a deeper legal significance, which was not lost on lawyers for the well-heeled corporate bond insurers whose small coterie of wealthy owners and investors stand to lose a percentage of their loan, what has become known—in the context of Europe's debt crisis—as the dreaded "haircut". Essentially, these banks and bond insurers are considered "unsecured creditors" whose debts would have to take a back seat to all those obligations that keep the city functioning on a day to day basis.

As Judge Klein explained in soaring language, "While the Contracts Clause is a key navigational star in the firmament of our Constitution and economic universe…it is subject to being eclipsed by the Bankruptcy Clause." If his allegiances weren't absolutely clear, Judge Klein concluded with what amounted to a signal flare to corporate creditors, "even if the plaintiffs' benefits are vested property interests, the shield of the Contracts Clause crumbles in the bankruptcy arena." (Ass'n of Retired Employees of the City of Stockton v. City of Stockton, 2012 WL 3193588 at *1-3 (Bankr. E.D. Cal.).)

Eager to take advantage of Judge Klein's friendly disposition, the bond insurer Assured Guaranty and National Public Finance Guarantee quickly filed their own opposition to Stockton's bankruptcy, arguing instead that Stockton had failed to properly attack the worker's pensions prior to petitioning for bankruptcy or in legal terms: it had failed to negotiate with creditors in "good faith" by sheltering CalPERS (California Public Employees Retirement System which provides retirement and health benefits to more than 1.6 million public employees, retirees, and their families) at the expense of other "similarly situated creditors".

In a comment to *California Lawyer* magazine, Karol K. Denniston, a bankruptcy specialist at Schiff Hardin in San Francisco, explained that if Stockton's corporate creditors can convince the court that workers' pensions can be dumped via the federal bankruptcy process, "that will lay down a precedent that would affect every city in California." More precisely: a precedent that would affect every *worker* in California and any other state that permits cities to file bankruptcy under chapter 9.

Reveling in Judge Klein's reasoning, Kevin J. Lyons, attorney for Assured Guaranty argued that federal bankruptcy power "trumps any purported state law priority for public worker pension benefits. As a result, the obligations owed to public employees will be treated like any other general unsecured claim." In other words, 1.6 million workers statewide are no more important than a handful of rich investors at Assured Guaranty, or any other parasitic financier.

The first hearing on Assured Guaranty's petition is scheduled for January. If Judge Klein endorses their argument, Stockton will have the legal backing, and critical political cover, to completely shred the pension rights of workers before encroaching on the hallowed interests of finance capital. Such an outcome would certainly be replicated throughout the state and the nation.