Campbell Law Review

Volume 37
Issue 1 *Symposium 2015*

Article 3

2015

Fair and Unfair Discrimination in Municipal Bankruptcy

Richard M. Hynes

Steven D. Walt

Recommended Citation

Richard M. Hynes and Steven D. Walt, *Fair and Unfair Discrimination in Municipal Bankruptcy*, 37 Campbell L. Rev. 25 (2015).

Fair and Unfair Discrimination in Municipal Bankruptcy

RICHARD M. HYNES[*] & STEVEN D. WALT[**]

ABSTRACT

Some bankrupt municipalities have proposed plans of reorganization that offer substantially greater recoveries to active workers and retirees than those offered to other creditors. Because these greater recoveries are not mandated by a priority enjoyed by the active workers and retirees, a judge can only approve such a plan if it does not "discriminate unfairly" against a class of disfavored creditors that votes against the plan. This Article describes the law defining the unfair discrimination standard, identifies the categories of circumstances in which discrimination between coequal classes is permitted, and argues that the claims of retirees and active workers do not fall into any of these categories. The Article concludes that the current law does not allow a judge to approve a reorganization plan that provides retirees and active workers with a greater recovery.

* Nicholas E. Chimicles, Research Professor in Business Law and Regulation, University of Virginia School of Law.

** Percy Brown, Jr., Professor of Law and John V. Ray Research Professor of Law, University of Virginia School of Law.

INTRODUCTION

Bankrupt cities and counties tend to have significant pension and other retirement obligations, but often times, very little money is set aside to pay such obligations.[1] These cities and counties generally have offered a much more generous recovery on these claims than the recovery offered for bonds and other general unsecured claims.[2] Until recently, the disfavored creditors

1. *See, e.g.*, Robert Novy-Marx & Joshua Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FIN. 1211, 1213–14, 1239 (2011).

2. *See, e.g.*, Dan Fitzpatrick, *Franklin, Calpers Clash on Stockton Pension Issue*, WALL ST. J. (July 7, 2014), http://online.wsj.com/articles/franklin-calpers-clash-on-stockton-pension-issue-1404772370 (reporting that the City of Stockton plans to pay some creditors less than 1% of their claims, while continuing to pay pensions in full); David Skeel, Op-Ed., *Detroit's Clever and Likely Illegal Art-for-Pensions Deal*, WASH. POST (May 9, 2014), http://www.washingtonpost.com/opinions/detroits-clever-and-likely-illegal-art-for-pensions-deal/2014/05/09/e3f93e84-cf1e-11e3-a6b1-45c4dffb85a6_story.html (noting that Detroit's plan would pay retirees 95% of their claims and bondholders 20% of their claims). The bankruptcy of Central Falls, Rhode Island, stands as an exception to this rule. In the Central Falls bankruptcy, the state legislature created a statutory lien that gave previously unsecured bondholders priority over the retirees. *See* Fourth Amended Plan for the Adjustment of Debts of the City of Central Falls, R.I., *In re* City of Cent. Falls, No. 11-13105 (Bankr. D.R.I. July 27, 2012), *available at* http://op.bna.com/bk.nsf/id/jhoz-8y3qp6/$File/CentralFallsFourth%20Amended%20Plan%20(7-27-12).pdf. As a result, the bondholders recovered in full, while the retirees received just 55% of their pensions. *See id.*; *see also* Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 REV. BANKING & FIN. L. 609, 617 n.30 (2013).

did not object to their treatment.[3] However, the municipal reorganization plans in Detroit and Stockton promised to pay pension and retirement claims a greater percentage than other unsecured claims with the same priority, and a number of creditors objected.[4] Judge Rhodes approved Detroit's bankruptcy plan over these objections,[5] and Judge Klein has stated that he will approve Stockton's plan.[6] This Article argues that bankruptcy's unfair discrimination standard prevents a municipality from granting workers and retirees a greater recovery than an objecting class of disfavored creditors. Although political considerations may induce a court to construe that standard to permit a municipal reorganization plan to favor workers and retirees, current law does not allow it.

If a municipality were liquidated under Chapter 7 of the Bankruptcy Code, the underfunded portion of the pensions would share pro rata with the other unsecured claims.[7] However, municipalities cannot be liquidated in Chapter 7 or reorganized under Chapter 11;[8] they are reorganized under Chapter 9.[9] Chapter 9 borrows most of its rules from Chapter 11,[10] the chapter that is typically used to reorganize corporations. Although courts and commentators frequently recite a bankruptcy norm of equal treatment,[11]

3. *See, e.g.*, Bobby White, *Bankruptcy Exit Approved for City*, WALL ST. J. (Aug. 6, 2011), http://online.wsj.com/news/articles/SB1000142405311190388560457648640277854l4 50 (noting that the City of Vallejo's largest creditors approved its plan of reorganization).

4. *See* Fitzpatrick, *supra* note 2 (noting Franklin Templeton Investment's fight against Stockton's plan); Mary Williams Walsh, *Bond Insurer Syncora Claims Mediator Favors Detroit's Retirees*, N.Y. TIMES (Aug. 12, 2014), http://dealbook.nytimes.com/2014/08/12/big-bond-insurer-syncora-files-objection-to-detroits-bankruptcy-plan/ (noting bond insurer Syncora's efforts to fight Detroit's reorganization plan).

5. Supplemental Opinion Regarding Plan Confirmation, Approving Settlements, and Approving Exit Financing at 169–81, *In re* City of Detroit, No. 13-53846 (Bankr. E.D. Mich. Dec. 31, 2014) [hereinafter Detroit Supplemental Opinion], *available at* http://www.mieb.uscourts.gov/sites/default/files/detroit/docket8993.pdf.

6. Transcript of Proceedings, *In re* City of Stockton, No. 12-32118-C-9 (Bankr. E.D. Cal. Oct. 30, 2014) [hereinafter Stockton Transcript], *available at* http://www.stocktongov.com/files/COS_Chapter9_ConfirmationHearingTranscript_2014_10_30_DRAFT_61pages.pdf ("[T]he Plan will be confirmed.").

7. *See* 11 U.S.C. §§ 726(a)(2), (b) (2012).

8. Only "persons" may file under Chapters 7 or 11, and a municipality is not a person under the Bankruptcy Code. *See id.* §§ 101(41), 109(b), (d).

9. *See id.* § 109(c).

10. *See id.* § 901(a).

11. *See* Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co., 547 U.S. 651, 667 (2006) (looking to "the equal distribution objective underlying the Bankruptcy Code" in reaching its holding); Sampsell 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), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138 ("[T]he preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.").

bankruptcy law recognizes many exceptions that give some creditors priority over others.[12] None of these exceptions, however, give retirees priority over general unsecured creditors to justify the disparity in repayment that municipalities would prefer.[13]

The reorganization plan determines the distribution to creditors within limits set by the Bankruptcy Code. One limit is that of equal treatment. The equal treatment norm states two different restrictions. If two claims have equal priority and are placed in the same class, the plan of reorganization must provide equal treatment to each.[14] Plans may discriminate between claims placed in different classes, however, as long as they do not "discriminate unfairly" against a class that votes against the plan.[15] Although the precise scope of this latter restriction is unclear, nearly all courts and commentators agree that a dramatic difference in recovery (such as the difference between the recoveries enjoyed by the retirees and general unsecured creditors) at least creates a strong presumption of "unfair discrimination."[16] Nonetheless, some circumstances can justify a departure from bankruptcy's norm of equal treatment of creditors with similar legal rights so that the discrimination is not unfair.[17]

Existing justifications for discrimination do not support the favorable treatment that some reorganization plans propose for active workers and retirees. This Article argues that such treatment is not the type of fair discrimination that is allowed by the Code. One justification for discriminatory treatment is that some creditors would receive more outside of bankruptcy than others.[18] This is not true when comparing retirees and bondholders. A second argument is that a claim can fairly receive a higher return if the creditor holding the claim contributes to the reorganization.[19] This Article argues that a better understanding of these cases is that the debtor does not, in fact, discriminate in favor of a claim; rather, it compensates the creditor for the new value given.[20] In any case, the contribution argument fails

12. *See* Hynes & Walt, *supra* note 2, at 613 (citing 11 U.S.C. §§ 506(b), 507(a)(1), 510(a), 725, 1129(b)(2)(A)).

13. *See id.* at 617–38.

14. 11 U.S.C. § 1123(a)(4).

15. *Id.* § 1129(b)(1).

16. *See, e.g.*, Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 228 (1998) (arguing for a presumption of unfair discrimination if there is "either (a) a materially lower percentage recovery for the dissenting class . . . or (b) . . . an allocation under the plan of materially greater risk to the dissenting class").

17. *Id.* ("The unfair discrimination in these situations is only presumptive.").

18. *Id.* at 257–58.

19. *Id.* at 260.

20. *See infra* notes 66–82 and accompanying text.

on its terms. It cannot justify the preferential treatment of retirees because they will not contribute to the reorganization. Nor can it justify the treatment received by active workers because the payment is not reasonably tied to their contribution.[21]

Most of the arguments made in support of a greater recovery for workers and retirees are normative. They rely on neither the treatment that active workers and retirees would receive outside of bankruptcy, nor their contribution to a reorganization, but on their poverty and their inability to protect themselves prior to bankruptcy.[22] These normative arguments are weak. Involuntary creditors such as tort claimants can make at least as compelling a normative argument for special treatment, but there is no support in the existing cases or commentary for the claim that creditors should receive more on account of their poverty or their inability to protect themselves.[23] Still, a court might allow a plan to favor creditors it deems to be deserving or needy. The court would be wrong to do so for two reasons. First, in other contexts, the Supreme Court has resisted efforts of bankruptcy courts to seize on language in the Code that seems to grant them equitable powers to rewrite priorities in bankruptcy.[24] Second, the argument that workers deserve more than other creditors is not as compelling as it might seem.[25]

The above analysis assumes that a disfavored class of claimants votes against the plan. A major creditor in Stockton's bankruptcy, however, has made similar unfair discrimination arguments, despite class approval of the plan.[26] It did so by trying to import unfair discrimination into another test—that the plan must be proposed in good faith.[27] This Article argues that this test is incorrect; Congress chose a class-based standard for a reason. The creditor's other arguments, however, have merit. More specifically, this

21. *See infra* notes 64–119 and accompanying text.

22. *See, e.g.*, Jack M. Beermann, *Resolving the Pension "Crisis*,*"* 41 FORDHAM URB. L.J. 999, 1022 (2014) (discussing how government workers are less able to diversify pension risks than small investors who can diversify financial risks); Maria O'Brien Hylton, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525, 544–47 (2013) (arguing that bondholders can better bear the loss than retirees because the bondholders have insurance and can better diversify the risk of default).

23. *See infra* notes 154–202 and accompanying text.

24. *See* United States v. Noland, 517 U.S. 535, 543 (1996) (holding that courts cannot use equitable subordination to change priorities on a categorical basis).

25. *See infra* notes 189–202 and accompanying text.

26. *See* Summary Objection of Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund to Confirmation of First Amended Plan of Adjustment of Debts of City of Stockton, California at 51–57, *In re* City of Stockton, No. 12-32118 (Bankr. E.D. Cal. Feb. 26, 2014) [hereinafter Franklin Summary Objection], *available at* http://bankrupt.com/misc/Stockton_Plan_Franklin_Obj.pdf.

27. *Id.*

Article concludes that Stockton has sought to evade the unfair discrimination standard by abusing its power to classify claims, and that the plan does not in fact treat members of the same class equally.[28]

Section I describes the existing understanding of the role of the unfair discrimination standard in bankruptcy reorganization. Section II applies this standard to municipalities' attempts to pay active workers and retirees more than general unsecured creditors. Section III examines Stockton's effort to evade this test through classification.

I. THE ROLE AND CONTENT OF THE UNFAIR DISCRIMINATION STANDARD

Under Chapter IX of the Bankruptcy Act,[29] applicable until 1978, a judge could not confirm a municipal reorganization plan without the consent of each class of creditors.[30] With the exception of the Detroit and Stockton bankruptcies,[31] all municipal reorganization plans under Chapter 9 of the Bankruptcy Code have been confirmed with a unanimous vote by class.[32] However, Chapter 9 incorporates Chapter 11's cramdown power.[33] This power allows the judge to approve the plan over the objection of a class as long as the plan meets bankruptcy's fairness standards with respect to that class.[34] Bankruptcy law contains two tests for horizontal fairness in reorganization. First, if the debtor places claims in the same class, either the claims must receive the same treatment, or holders of disfavored claims must consent to their inferior treatment.[35] Because it requires equal treatment, this test ensures intraclass fairness in everything but name.[36] Second, if claims are placed in separate classes, the plan cannot unfairly discriminate against a class

28. *See infra* notes 233–61 and accompanying text.

29. *See* 11 U.S.C. §§ 401–403 (1976) (originally enacted as Act of Aug. 16, 1937, ch. 657, 50 Stat. 653, 657–58).

30. *See id.* § 403 (current version at 11 U.S.C. § 903 (2012)).

31. Two classes of claims rejected Detroit's plan and Judge Rhodes explicitly invoked bankruptcy's cramdown power. *See* Detroit Supplemental Opinion, *supra* note 5, at 169–84. In approving Stockton's plan, Judge Klein stated that all impaired classes had approved the plan. *See* Stockton Transcript, *supra* note 6, at 37. When the city's attorney corrected him, noting that a class of tort claimants rejected the plan, Judge Klein replied that these creditors logically fit with the general unsecured creditors and did not conduct a cramdown analysis. *Id.* at 42–43.

32. *See* Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy*,*"* 59 UCLA L. REV. 322, 335 n.74 (2011).

33. *See* 11 U.S.C. § 901 (2012) (incorporating 11 U.S.C. § 1129(b)(1) by reference).

34. *Id.* § 1129(b)(1).

35. *Id.* § 1123(a)(4).

36. *See In re* Simmons, 288 B.R. 737, 747 (Bankr. N.D. Tex. 2003) (stating that the test provides a horizontal standard to fairness).

that rejects the plan.[37] By its terms, this test ensures interclass fairness. The same language prohibiting unfair discrimination appears in the other reorganization chapters as well.[38]

Some commentators believe that the test for unfair discrimination differs depending on whether the debtor is reorganizing in Chapter 11 or in Chapter 13.[39] This Article disagrees. The choice of bankruptcy relief has nothing to do with the requirement that the reorganization plan not unfairly discriminate against a class of claims. Although the different bankruptcy chapters offer different types of relief for debtors, the standard of unfair discrimination applicable in those chapters remains the same.[40] Similarly, the standard of unfair discrimination is the same across bankruptcy chapters, even though some chapters differ as to the party with standing to object to unfair discrimination.[41] Finally, a limitation on the application of the standard in a chapter does not mean that unfair discrimination has a different interpretation in that chapter.[42] The unqualified incorporation of the same "not discriminate unfairly" language into each of the reorganization chapters reinforces this conclusion.[43] Case law also supports this conclusion, relying on

37. 11 U.S.C. § 1129(b)(1).

38. *See id.* §§ 1222(b)(1), 1322(b)(1).

39. *See* Markell, *supra* note 16, at 244–46. Judge Rhodes made a similar argument in the Detroit bankruptcy, stating that courts should apply a more lenient unfair discrimination standard in Chapter 9 because "the purpose of chapter 9 is to restructure the municipality's debt so that it can provide adequate municipal services" and because "chapter 9 leaves the municipality in control of its affairs while facilitating its debt restructuring." *See* Detroit Supplemental Opinion, *supra* note 5, at 175.

40. *See* 11 U.S.C. § 1101 (reorganization); *id.* §§ 901, 1201, 1301 (debt adjustment).

41. *Cf. id.* § 1322(b)(1) (stating that a holder of an individual claim may object); *id.* § 1129(b)(1) (stating that only a holder of a claim in a rejecting class may object). Although a court might wish to consider the degree of creditor opposition as an evidentiary matter, this does not change the substance of the standard. The 1978 Act radically changed the standing requirements. *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 2649. Under the Chandler Act, unfair discrimination objections were not restricted to claims in rejecting classes. *See* Chandler Act of June 22, 1938, ch. 575, 52 Stat. 840, *repealed by* Bankruptcy Reform Act of 1978. In fact, Chapter IX lacked a cramdown power; if a class voted against a plan, it could not be approved, regardless of how fair the judge believed it to be. *See id.* Although individual creditors did not have standing to raise an unfair discrimination objection, *see In re* Stanley Drug Co., 22 F. Supp. 664 (E.D. Pa. 1938), such objections were unnecessary. The bankruptcy judge was required to assess independently whether the plan unfairly discriminated against a class, *see* 11 U.S.C. § 766(3) (1946) (requiring that a plan be "fair and equitable"), just as a bankruptcy judge today must independently determine that a plan is feasible under the Bankruptcy Code, *see id.* § 1129 (a)(11) (2012).

42. *See* 11 U.S.C. § 1322(b)(1) (indicating that a Chapter 13 debtor's plan may discriminate in favor of a consumer claim for which the debtor has a co-debtor).

43. *See id.* §§ 901(a), 1129(b)(1), 1322(b)(1).

interpretations of unfair discrimination in Chapters 9, 11, and 13, without regard to the bankruptcy chapter in which the standard appears.[44]

Courts generally state a standard of unfairness based on a four-part "test." According to the test, discrimination is fair only if: (1) it has a reasonable basis; (2) it is necessary to carry out the plan; (3) it is proposed in good faith; and (4) it is related to the basis for the discrimination.[45] This "test" is poorly designed. The requirement that the discrimination be proposed in good faith is superfluous, given the separate requirement that the reorganization plan be proposed in good faith.[46] In addition, only the second requirement is informative.[47] If a plan cannot be implemented without disfavoring a class, the discrimination is necessary to implement the plan. This demanding requirement is unlikely to be met in most cases.[48] Without an alternative plan that is otherwise preferable but does not disfavor the class, the discrimination against the class is fair. The other factors are uninformative. Discrimination that has no reasonable basis is irrational, arbitrary, and therefore, unfair. For its part, discrimination that is unrelated to the basis for discrimination is unfair. As for the third requirement, a plan calling for discrimination that is proposed in bad faith, solely to harm the disfavored class, is also unfair.

Cases involving different treatment of coequal classes are difficult and controversial in part because their resolution requires application of a standard of unfair discrimination.[49] The trouble with the four-part test is that it does not

---

44. *See, e.g.*, Ownby v. Jim Beck, Inc. (*In re* Jim Beck, Inc.), 214 B.R. 305, 307 (W.D. Va. 1997) (citing and relying on *In re* Aztec Co., 107 B.R. 585, 589–90 (Bankr. M.D. Tenn. 1989) (applying case law interpreting § 1322(b)(1) to be the same as § 1129(b)(1)'s interpretation), *aff'd per curiam*, 162 F.3d 1155 (4th Cir. 1998)); *In re* Simmons, 288 B.R. 737, 747 n.32 (Bankr. N.D. Tex. 2003) ("There appears to be no reason to assume that Congress intended different meanings for the term 'unfair discrimination' in chapters 11 and 13 . . . .").

45. *See, e.g.*, Mickelson v. Leser (*In re* Leser), 939 F.2d 669, 672 (8th Cir. 1991); AMFAC Distrib. Corp. v. Wolff (*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); Comm. on Bankr. & Corporate Reorganization, Ass'n of the Bar of N.Y.C., *Making the Test for Unfair Discrimination More "Fair": A Proposal*, 58 BUS. LAW. 83, 88, 90 (2002) (describing the four-part test as the one most widely used by courts).

46. *See* 11 U.S.C. §§ 901(a), 1129(a)(3), 1325(a)(3).

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

48. *See infra* notes 64–119 and accompanying text.

49. For instances of controversy over the proper standard of unfair discrimination to apply, see, for example, *In re* Armstrong World Indus., Inc., 348 B.R. 111, 122 (D. Del. 2006) (applying the "rebuttable presumption" approach); *In re Jim Beck, Inc.*, 214 B.R. at 307 (affirming the bankruptcy court's application of the "four-part test"); *In re* Greystone III Joint Venture, 102 B.R. 560, 571–72 (Bankr. W.D. Tex. 1989) (applying the mechanical approach), *rev'd sub nom.* Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274 (5th Cir. 1991).

tell a court which considerations make a difference in treatment that is reasonable, nor does it describe the permissible range of differences in treatment. It merely tells the court what the court already knows: that a reasonable basis for a difference in treatment or a difference in treatment within a permissible range is fair. Nearly all courts and commentators recognize a presumption of unfair discrimination if one class of claims or interests receives a much higher rate of recovery or is exposed to less risk than a coequal class of claims or interests.[50] The difficulty is determining the point at which the disparity in distribution or risk triggers the presumption. Without a standard of unfair discrimination, setting the presumption at one point rather than another is arbitrary.

A. Equal Treatment and Unfair Discrimination

The Bankruptcy Code and case law applying it suggests a standard of unfair discrimination. Bankruptcy law begins with a principle of equal distribution among creditors: creditors share equally in proportion to their claims.[51] Nonetheless, the Code explicitly recognizes departures from this principle of pro rata sharing by giving some claims priority over others.[52] For example, certain tax claims are given priority over other unsecured claims.[53] The Code also gives effect to priority established by contract between creditors. Thus, if one creditor agrees to subordinate its interest to another, the Code honors the agreement.[54] Finally, the Code recognizes property rights created outside of bankruptcy that give some creditors priority over others. For example, it generally gives effect to nonbankruptcy-law rules that give a secured creditor priority with respect to its collateral over a general creditor.[55] Subject to these important exceptions, the Code enforces a principle of equal treatment of claims. This is the principle that courts routinely recite.[56]

---

50. *See, e.g.*, *In re Armstrong World Indus.*, 348 B.R. at 121–22; *In re* Aleris Int'l, Inc., No. 09-10478, 2010 Bankr. LEXIS 2997, at *95 (Bankr. D. Del. May 3, 2010); 7 COLLIER ON BANKRUPTCY ¶ 1129.03[3][b], at 1129-67 to -68 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2014); Markell, *supra* note 16, at 228.

51. *See supra* note 11 and accompanying text.

52. *See, e.g.*, 11 U.S.C. § 507(a) (2012) (granting some claims priority over general unsecured creditors).

53. *Id.* § 507(a)(8).

54. *Id.* § 510(a).

55. *See id.* §§ 506(a), 725.

56. *See* Am. United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 147 (1940) (stating that the general rule of "equality between creditors" is applicable to all bankruptcy proceedings).

Bankruptcy's standard of unfair discrimination includes the principle of equal treatment, but allows for unequal treatment if that treatment is fair.[57] In this way, the Code's unfair discrimination standard is a further exception to the bankruptcy principle of pro rata sharing—a principle of equality. A class is discriminated against if what it is promised under the plan is different from what is promised to another class holding the same claims with the same priority.[58] In a straightforward way, the plan treats the disfavored differently from the favored class—unequally. However, the Code's standard of unfair discrimination prohibits the different treatment only if the different treatment is unfair.[59] Promising Class *A* 50% and Class *B* 75% payouts of their respective claims does not by itself unfairly discriminate against Class *A*. Because the Code permits discrimination if the difference in treatment is fair, the standard of unfair discrimination requires more than a violation of the principle of pro rata sharing.

Although the Code does not say when discrimination is fair, case law and common sense do. Case law recognizes circumstances in which there is good reason for the reorganization plan to treat two classes of claims differently. In these circumstances, the different treatment is found to be "fair." Four circumstances can be identified in which a plan might propose to favor one class over another: (1) when the favored class has priority over the disfavored class;[60] (2) when a class contributes value to the debtor;[61] (3) when it is necessary for the plan to favor one class over another;[62] and (4) when the plan favors one class over another for reasons other than contribution or necessity.[63] Courts have deemed the different treatment fair in the first three types of circumstances. Subsection B describes the four categories of circumstances, and Section II argues that neither the Code nor case law allows different treatment in the fourth circumstance.

B. *Fair Discrimination*

As stated above, a departure from the Code's principle of equal treatment might be fair in four circumstances. The Code or the predominant case law recognizes three of the four circumstances. The fourth scenario is controversial and finds no support in the Code or in relevant cases.

57. *See* Markell, *supra* note 16, at 228.
58. *Id.*
59. *Id.*
60. *See infra* notes 64–65 and accompanying text.
61. *See infra* notes 66–82 and accompanying text.
62. *See infra* notes 83–107 and accompanying text.
63. *See infra* notes 108–19 and accompanying text.

1. *Priority*

The Code recognizes the priority of certain claims over others.[64] Because a claim with priority is paid before one without priority, the claims are treated differently. It cannot be unfair discrimination, in the relevant sense of the phrase, for a plan to pay different amounts to priority claims than to other claims. Otherwise, a plan could not respect both the Code's priority scheme and the unfair discrimination standard, unless the debtor was solvent. Courts agree, finding that the standard applies only when the plan proposes to pay different classes of claims having the same priority.[65] Thus, a plan does not unfairly discriminate against junior claims when it proposes higher payouts for senior claims. The category of priority is fairly obvious and uncontroversial.

2. *Contribution*

Contribution is another circumstance in which different treatment of creditors is fair.[66] If a plan promises to pay one creditor's claim more than the claims of other creditors in exchange for that creditor's contribution to the reorganization, the plan does not treat the disfavored creditors unfairly. The contributing creditor's favorable treatment is on account of its contribution, not on account of its prepetition claim. Predominant case law considers the difference in contribution to justify a difference in treatment.[67]

To better understand this argument, consider facts that are not ordinarily thought of as involving unfair discrimination. Assume that a debtor's plan promises to pay all unsecured creditors 50% of their claims. One creditor is a supplier and continues to deliver widgets to the debtor during the reorganization process. In exchange, the debtor promises to pay the supplier some additional amount for the new widgets, say $100. The other creditors might argue that the supplier's $100 claim should not be allowed as an administrative expense because it is not an actual and necessary cost of preserving the estate.[68] Suppose, however, that the debtor pays the supplier before the plan is confirmed, under its authority to use assets in the ordinary course of business.[69] Under existing law, a creditor in a class that rejects the plan can object and argue that the $100 payment constitutes unfair discrimination because the payment was really on account of the supplier's

64. *See supra* notes 50, 52–56 and accompanying text.

65. *See, e.g.*, *In re* Armstrong World Indus., Inc., 348 B.R. 111, 121–22 (D. Del. 2006); *In re* BWP Transp., Inc., 462 B.R. 225, 232 (Bankr. E.D. Mich. 2011); *In re* Simmons, 288 B.R. 737, 748 (Bankr. N.D. Tex. 2003).

66. *See, e.g.*, Markell, *supra* note 16, at 228.

67. *See, e.g.*, Mason v. Paradise Irrigation Dist., 326 U.S. 536, 543 (1946).

68. *See* 11 U.S.C. § 503(b)(1)(A) (2012).

69. *See id.* § 363(c)(1).

prepetition claim.[70] If a creditor makes this objection, the analysis will be very similar to that of the administrative expense objection. The court will ask whether the $100 paid to the supplier is a reasonable estimate of the contribution made and thus, should not be presumed to be on account of the prebankruptcy claim.

This precedent was established in *American United Mutual Life Insurance Co. v. City of Avon Park*,[71] the first modern unfair discrimination case. In *Avon Park*, in a Chapter IX arrangement under the Bankruptcy Act, the municipality contracted with an agent to help obtain the necessary acceptance by creditors.[72] The agent was also the municipality's creditor.[73] The agent received a fee collected from bondholders that was calculated differently depending on whether the bondholders sold their interest coupons to the party.[74] Because the lower court found that this fee was reasonable in light of the services provided, it concluded that the compensation did not discriminate unfairly in favor of the agent.[75] However, the agent also purchased bonds at a discount, and the lower court did not determine the reasonableness of the profit that the agent would earn on these bonds.[76] The Court considered this reversible error.[77]

Avon Park stands for the proposition that a court applying the unfair discrimination standard must consider all of the benefits received by the creditor on account of its claim in the reorganization, not just those designated as the repayment of its claim under the plan.[78] Discrimination is fair only if it is reasonable, taking into account the contribution made and all of the benefits realized by the party.[79]

The more frequent unfair discrimination cases do not involve cash payment for a creditor's contribution. Instead, they usually involve favorable treatment of the creditor's prepetition claim in light of its contribution to the

70. *See id.* § 1129(b)(1) (requiring that a plan not discriminate unfairly against a class of impaired claims that has rejected the plan).

71. Am. United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138 (1940).

72. *Id.* at 141.

73. *Id.* at 142–43.

74. *Id.* at 141.

75. *Id.* at 143.

76. *Id.*

77. *Id.* at 148 ("In absence of a finding that the aggregate emoluments receivable by the [agent's] interests were reasonable, measured by the services rendered, it cannot be said that the consideration accruing to them, under or as a consequence of the adoption of the plan, likewise accrued to all other creditors of the same class.").

78. *See id.* at 144.

79. *See id.*

reorganization.[80] In such a scenario, the debtor argues that the favorable treatment is not on account of the claim, but on account of the creditor's contribution.[81] The debtor pays for the contribution by increasing the payment of the creditor's prepetition claim rather than in cash. Nonetheless, the proposition stated in *Avon Park* still applies. How the debtor structures the payment to a creditor for its prepetition claim and its new contribution is merely a formality. Courts must examine the substance of the transaction to ensure that a creditor is not receiving more on account of its prepetition claim than other creditors receive on their claims with the same priority.[82] The task is a little more difficult when the debtor formally structures the payment for the contribution as a repayment of the prepetition claim, but a court can still calculate the additional recovery awarded to the contributing creditor and ask whether this is a reasonable price for the creditor's services.

3. Necessity

Favorable treatment of a class might sometimes be needed to confirm a reorganization plan.[83] Without favorable treatment, the only alternative could be to liquidate the debtor's assets, either as part of a Chapter 7 case or a Chapter 11 liquidating reorganization.

Some cases designated as necessity cases are better understood as contribution cases. For example, assume that the debtor wants to offer a greater recovery rate to a favored supplier or its existing workers because it fears that they would refuse to deal with the debtor otherwise. The debtor's

80. *See, e.g.*, Markell, *supra* note 16, at 241.

81. The contribution exception is similar to the new-value exception to the absolute-priority rule. In the new-value context, debtors argue that a holder of a junior claim or interest is not receiving value on account of their claim or interest but rather in exchange for some new value or contribution made. Although the Supreme Court has not affirmed the new-value exception, it has said that the exception, if it exists, must be limited to ensure that the new value is at least as valuable as what the holder of the claim or interest receives. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 (1999). More specifically, the Supreme Court insists that the new value be "in money or in money's worth" and that the exchange be subject to a "market test." *See id.* at 445, 458 (quoting Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 122 (1939)). Similarly, the contribution exception to the unfair discrimination standard requires that favorable treatment under the plan be on account of the contribution, not on account of a prepetition claim. The required form of the contribution and the test for its presence are separate matters that this Article does not address.

82. Bankruptcy courts routinely look to the substance of the transaction and disregard its form. *See, e.g.*, *In re* LTV Steel Co., 274 B.R. 278, 286–87 (Bankr. N.D. Ohio 2001).

83. *See, e.g.*, *In re* Perskin, 9 B.R. 626, 632 (Bankr. N.D. Tex. 1981) (stating that it was fair to discriminate in favor of credit-card debt when the debtor needed continued access to cards to continue his business as a traveling salesman); *In re* Ragsdale, 15 B.R. 668, 670–71 (Bankr. N.D. Ga. 1980) (ordering fair discrimination in favor of the creditor, partly secured by a car needed for the debtor's business).

argument is best understood as favored treatment based on contribution: the proposal is to pay for the supplier or workers' contributions in supplies or labor by favoring their prepetition claims. Following *Avon Park*, courts should ask whether the value of the contributed supplies or services is commensurate with what the debtor gives to the favored creditor under the plan plus any other consideration paid.[84] If not, their enhanced recovery will reduce the total creditor recovery and must come at the expense of the disfavored creditors. In these circumstances, courts should reject the plan as unfairly discriminatory.

Other cases are genuine instances of necessity. For example, full payment of wage claims might be the price of a labor union's continued cooperation, which the debtor needs to stay in business.[85] If these claims are not paid, the union may induce potential buyers not to purchase the debtor's products. Here, the labor union is not contributing something to the debtor. Payment of wage claims is merely the price of the union not carrying out its threat.[86] If the alternative is liquidation, the test is one of profitability. Favorable treatment is fair when it is necessary for the profitability of the reorganized debtor.[87] The proposed wage payment therefore does not unfairly discriminate against the debtor's disfavored creditors.

The profitability test of necessity requires a showing that without the favorable treatment, the reorganized debtor would operate at a loss and be forced to liquidate. The debtor must establish that suppliers or employees would fail to continue providing goods or services, even at a competitive rate of return, unless the reorganization plan treated their prepetition claims favorably.[88] The showing is likely to be credible in very few plans. More important, the profitability test of necessity has no application to municipal bankruptcies under Chapter 9. This is because the purpose of a municipality's Chapter 9 bankruptcy is only to relieve the municipality of its burdensome debt obligations, not to efficiently redeploy its assets.[89] Relieving the

---

84. *See supra* notes 78–82 and accompanying text.

85. *See In re* Kliegl Bros. Universal Elec. Stage Lighting Co., 149 B.R. 306, 309 (Bankr. E.D.N.Y. 1992) (stating that a 75% distribution on union members' wage claims did not unfairly discriminate in the face of a threat of strike when a union shop was needed to remain in the industry).

86. A few courts have sanctioned lesser threats as willful violations of the automatic stay. *See, e.g.*, Sportfame of Ohio, Inc. v. Wilson Sporting Goods Co. (*In re* Sportfame of Ohio, Inc.), 40 B.R. 47, 53 (Bankr. N.D. Ohio 1984) (holding that a threat to refuse future goods and services unless prior debt was paid violated the automatic stay); *accord* Olson v. McFarland Clinic, P.C. (*In re* Olson), 38 B.R. 515, 519 (Bankr. N.D. Iowa 1984).

87. Markell, *supra* note 16, at 261.

88. *See supra* notes 85–86 and accompanying text.

89. *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 469–70 (1993). Chapter 9 limits

municipality from its debts only requires the municipality to generate sufficient revenues to pay creditors the amounts promised under the plan, consistent with maintaining basic municipal services.[90] It does not require the municipality to generate revenues in excess of operating costs. The profitability test can be modified in the case of municipalities to allow favorable treatment of a class only if, without the treatment, the municipality could not carry out its plan. Even as modified, however, the test remains strict. It requires establishing that employees or suppliers of goods or financing will refuse to continue providing their inputs, even at a competitive rate of return, unless their prepetition claims are favored. This showing is unlikely to be made successfully in most circumstances.

The necessity justification has a lot in common with the doctrine of necessity or critical vendor payments. Judge Easterbrook's opinion in *In re Kmart Corp.*[91] is instructive. Critical vendor payments are full repayments of favored creditors at the outset of bankruptcy.[92] They amount to fair discrimination in favor of the critical vendor prior to the confirmation of the plan.[93] In *Kmart*, Judge Easterbrook accepted the possibility that the Code could authorize critical vendor payments.[94] Nonetheless, he denied the debtor's authority to make them because he found that the debtor failed to demonstrate that the critical vendors would otherwise refuse to supply it, or that the disfavored creditors would be made better off.[95] Judge Easterbrook further argued that it will be hard for the debtor to make such a showing, in part because the debtor offers a credit enhancement to assure suppliers of

---

the authority of a court to order the municipality to dispose assets or increase fees or taxes. *See* 11 U.S.C. § 904(2) (2012) (stating that unless the municipality or plan provides otherwise, the court may not interfere with municipal assets or revenue); *In re* N.Y.C. Off-Track Betting Corp., 434 B.R. 131, 140 (Bankr. S.D.N.Y. 2010) (citing 11 U.S.C. § 904 and U.S. CONST. amend. X to support the proposition that bankruptcy courts are unable to dispose of municipal assets without the debtor's consent).

90. *See* 11 U.S.C. § 928(b) (stating that liens on special revenues shall be subject to the municipality's necessary operating expenses).

91. *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004). In fact, Judge Easterbrook explicitly relied on an unfair discrimination case from Chapter 13. *See id.* at 874 (citing *In re* Crawford, 324 F.3d 539 (7th Cir. 2003)).

92. *Id.* at 868.

93. *Id.* at 874 (noting that critical vendor payments discriminate among creditors and are considered fair upon a showing that the preference has a prospect of benefit for the other creditors).

94. *Id.* at 872.

95. *Id.* at 873–74.

payment.[96] Despite Judge Easterbrook's skepticism, critical vendor payments remain fairly routine.[97]

Courts that allow "necessity" to justify discriminatory treatment in a reorganization plan should require debtors to demonstrate true necessity.[98] They often do not.[99] The debtor should be required to demonstrate that it could not use alternative means to secure future goods or services such as letters of credit or the full funding of its pensions. Too often, however, courts approve discrimination on a mere assertion of need.[100]

One circumstance that can occur in a Chapter 11 reorganization might fit under the necessity category. Assume that a debtor files for bankruptcy in Chapter 11. The debtor has a creditor with an undersecured nonrecourse claim and a number of trade creditors with unsecured claims against it. Unless the undersecured creditor elects to have its entire claim treated as secured, § 1111(b) deems the undersecured nonrecourse claim to have recourse against the debtor in Chapter 11.[101] Suppose that the creditor does not elect to have its entire claim treated as secured. In this case, the creditor is deemed to hold two claims: an unsecured claim in the amount of the deficiency, and a secured claim in the amount of the value of the collateral.[102] Suppose, too, that the

96. *Id.* at 873.

97. *See, e.g.*, *In re* Jeans.com, 502 B.R. 250, 259 (Bankr. D.P.R. 2013); *In re* Tropical Sportswear Int'l Corp., 320 B.R. 15, 17 (Bankr. M.D. Fla. 2005). For the frequent issuance of critical vendor orders before *Kmart*, see LYNN M. LOPUCKI, COURTING FAILURE 163–67 (2005); *but see* Timothy M. Lupinacci & Daniel J. Ferretti, *Recent Trends in Critical Vendor Jurisprudence Post-*Kmart, NORTON BANKR. L. ADVISER, Apr. 2009, at 1 (arguing that since *Kmart*, courts have been more reluctant to allow critical vendor payments).

98. In *Kmart*, Judge Easterbrook also stated that the debtor must show that the other creditors would receive more than they would receive in a liquidation. *Kmart*, 359 F.3d at 872–73. This test should be stricter. The "best interests of creditors" test ensures that a creditor receives at least this amount; unfair discrimination would be superfluous if it did not require more.

99. *See, e.g.*, *In re* Kliegl Bros. Universal Elec. Stage Lighting Co., 149 B.R. 306, 309 (Bankr. E.D.N.Y. 1992) (finding that discrimination was fair where it was based on an unsupported allegation of need to avoid a strike); *In re* Furlow, 70 B.R. 973, 977 (Bankr. E.D. Pa. 1987) (holding that a debtor is not required to establish that a plan cannot be confirmed without favorable treatment of a claim—proof of a rational basis for the treatment is sufficient); *In re* Perskin, 9 B.R. 626, 632 (Bankr. N.D. Tex. 1981) (finding discrimination to be reasonable absent a showing that a plan favoring credit-card debt was the only possible plan).

100. *See In re Kliegl Bros.*, 149 B.R. at 309. *But cf. In re* Graphic Commc'ns, Inc., 200 B.R. 143, 149 (Bankr. E.D. Mich. 1996) ("[T]he debtor has not demonstrated that its treatment of Midwest's claim is necessary to successfully reorganize, or that it could not carry out a plan of reorganization that did not discriminate between Class III and Class IV."); *In re* ARN LTD. Ltd. P'ship, 140 B.R. 5, 12 (Bankr. D.D.C. 1992) (refusing to justify discrimination based on "speculation" that discrimination was necessary).

101. 11 U.S.C. § 1111(b) (2012).

102. *Id.* § 506(a)(1).

debtor's reorganization plan puts the deficiency claim and the claims of the trade creditors in different classes and proposes to pay the trade creditors in full and the deficiency claim nothing.[103] Finally, assume that the going-concern value is insufficient to pay both the deficiency claims and the trade creditors in full, but that the liquidation value of the debtor's assets that do not serve as collateral for the undersecured claim is sufficient to pay the trade creditors in full. The creditor votes its deficiency claim to reject the plan.

On these assumptions, the plan arguably does not unfairly discriminate against the deficiency claim. This is because Chapter 11 requires a claim holder to receive under the plan at least as much as it would receive in a Chapter 7 liquidation, unless it has accepted the plan.[104] In a Chapter 7 liquidation, the nonrecourse creditor has no deficiency claim and therefore receives no distribution on account of it.[105] By contrast, under the ongoing assumptions, in a Chapter 7 liquidation, the debtor has sufficient assets to pay the trade creditors in full. As a result, the trade creditors can block any Chapter 11 plan that does not propose full payment. Because the debtor's going-concern value does not allow for the full payment of both the trade creditors and the deficiency claim, only a plan that discriminated between the claims can be approved.[106] Thus, the plan's discrimination in favor of the trade creditors is necessary. Although the circumstance described can arise in a Chapter 11 reorganization, it cannot arise in a Chapter 9 municipal bankruptcy. This is because unlike Chapter 11, Chapter 9 does not give a nonrecourse claim a deficiency.[107]

4. "Other"

Falling under the "other" category are circumstances in which favorable treatment of a class is fair without priority, contribution, or necessity making it so. This residual category includes favorable treatment based on administrative convenience.[108] Occasionally, providing for an equal proportionate distribution among coequal classes might not be cost-

103. This hypothetical is closely based on the facts of *Bank of America National Trust Savings Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999).

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

105. *See id.* § 103(g) (limiting § 1111(b) to bankruptcies filed under Chapter 11).

106. The Seventh Circuit accepted this argument in *Bank of America National Trust Savings Ass'n v. 203 North LaSalle Street Partnership*, 126 F.3d 955, 969 (7th Cir. 1997), *rev'd on other grounds*, 526 U.S. 434 (1999).

107. *Cf.* 11 U.S.C. § 901(a), which does not incorporate § 1111(b).

108. *See, e.g.*, *In re* Cello Energy, LLC, Nos. 10-04877-MAM-11, 10-04931-MAM-11, 10-04930-MAM-11, 2012 Bankr. LEXIS 1533, at *46–47 (Bankr. S.D. Ala. Apr. 10, 2012); *In re* Storberg, 94 B.R. 144, 146 (Bankr. D. Minn. 1988).

justified.[109] Valuing different sorts of consideration to be given to different classes to assure that they have exactly the same present value can be costly. The differences can be slight enough not to justify the effort needed to assure an exactly equal proportionate distribution. Alternatively, significant bookkeeping costs can be incurred in paying the members of a large class of creditors over time to assure that they receive exactly the same present value as other coequal classes.[110] In these circumstances, administrative convenience allows differences in treatment to be fair.

The cases do not usually address administrative convenience.[111] However, they rely on the standard of unfair discrimination to justify different treatment. Some courts require demonstration of a "reasonable basis" for favorable treatment.[112] This requires the plan proponent to establish the basis for the treatment. A showing that even the disfavored class benefits from avoiding a costly valuation exercise establishes a reasonable basis for a small difference in the percentage of payments between coequal classes.[113] A line of cases invokes the rebuttable presumption that a plan that provides for a materially greater percentage recovery to a coequal class unfairly discriminates against the disfavored class.[114] Small differences in payments promised to coequal classes do not trigger the presumption, because they are not material.[115] The absence of the presumption aids the plan proponent, by easing the burden of proving that administrative convenience makes the

109. *See, e.g.*, *In re Cello*, 2012 Bankr. LEXIS 1533, at *46–47 (holding that an immediate cash payment to the class was not unfair discrimination for administrative reasons because it reduced bookkeeping costs).

110. *See id.*

111. For exceptions, see, for example, *id.*; *In re Storberg*, 94 B.R. at 146.

112. *See* Markell, *supra* note 16, at 242–43 (citing *In re* Aztec Co., 107 B.R. 585, 590 (Bankr. M.D. Tenn. 1989)); *see also supra* note 45 and accompanying text.

113. *Cf.* Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518–19 (2d Cir. 1988) (citing Chem. Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966)); *In re* Commercial Envelope Mfg. Co., Nos. 76 B 2354, 76 B 2355, 76 B 2356, 76 B 2357, 1977 Bankr. LEXIS 15, at *10 (Bankr. S.D.N.Y. Aug. 22, 1977) (discussing substantive consolidation where the affairs of different entities are so entangled that all creditors benefit from consolidation, but ultimately holding that such a level of entanglement was not present under the facts).

114. *See, e.g.*, *In re* Armstrong World Indus., Inc., 348 B.R. 111, 121–22 (D. Del. 2006); *In re* Prosperity Park, LLC, No. 10-31399, 2011 Bankr. LEXIS 1852, at *10 (Bankr. W.D.N.C. May 17, 2011) (citing *In re* Dow Corning Corp., 244 B.R. 705, 710–11 (Bankr. E.D. Mich. 1999)); *In re* Genesis Health Ventures, Inc., 266 B.R. 591, 611–12 (Bankr. D. Del. 2001).

115. *See In re Armstrong World Indus.*, 348 B.R. at 121–22; *In re Prosperity Park*, 2011 Bankr. LEXIS 1852, at *10 (citing *In re Dow Corning Corp.*, 244 B.R. at 710–11); *In re Genesis Health Ventures*, 266 B.R. at 611–12.

favorable treatment reasonable, because it benefits even the disfavored class.[116]

Another circumstance unrelated to priority, contribution, or necessity that in principle could justify favorable treatment is the favored creditor's status. Moral notions of fairness, including a creditor's vulnerability or need, might argue for favoring the creditor's claims over coequal claims. Nonetheless, case law rejects this basis for discriminating against creditors. The majority of cases find that a creditor's status as unsecured tort creditor or holder of a nondischargeable student debt is an insufficient ground for giving the creditor's claim preferential treatment.[117] Similarly, the terms of a debt, such as its length, alone do not justify different treatment from claims with the same priority.[118] Courts reason that the character of the creditor or nature of its claim is not a permissible basis for favorable treatment unless the Code gives the creditor's claim priority. Even the courts that allow favorable treatment of nondischargeable student debt do so based on a statutory argument for the treatment.[119] A reasonable inference from the case law on the subject is that moral notions of fairness that find no support in the Code do not inform the unfair discrimination standard.

II. UNFAIR DISCRIMINATION: MUNICIPAL WORKERS AND RETIREES

Part I identified four categories of discrimination that might be fair: (1) favorable treatment in recognition of a legal priority enjoyed by the favored creditor; (2) favorable treatment in recognition of a contribution made by the favored creditor; (3) favorable treatment necessary for a successful reorganization; and (4) favorable treatment supported by "other" considerations. This Part evaluates whether the justifications organized by these categories allow a municipality's reorganization plan to favor the

116. *See In re* Mount Carbon Metro. Dist., 242 B.R. 18, 31 (Bankr. D. Colo. 1999) (holding that the municipality bears the burden of proving that its plan satisfies the confirmation requirements of § 943).

117. *See, e.g.*, Gorman v. Birts (*In re* Birts), No. 1:12cv427 (LMB/TCB), 2012 U.S. Dist. LEXIS 107811, at *9–10 (E.D. Va. Aug. 1, 2012); *In re* Thibodeau, 248 B.R. 699, 702–03 (Bankr. D. Mass. 2000); *In re* Chapman, 146 B.R. 411, 417–18 (Bankr. N.D. Ill. 1992) (analyzing the holders of nondischargeable student debt).

118. *See, e.g.*, *In re* Zeigafuse, No. 11-20854, 2012 Bankr. LEXIS 1463, at *13 (Bankr. Wyo. Apr. 5, 2012) (holding that the contested plan unfairly discriminated in favor of a student-loan creditor); *In re* Simmons, 288 B.R. 737, 749 (Bankr. N.D. Tex. 2003) (analyzing the terms of a loan that exceeded the Chapter 13 plan period).

119. *See, e.g.*, *In re* Truss, 404 B.R. 329, 334 (Bankr. E.D. Wis. 2009); *In re* Cox, 186 B.R. 744, 746–47 (Bankr. N.D. Fla. 1995) (allowing favorable treatment of student debt under a plan supported by inference from 11 U.S.C. § 1322(b)(5) (2012) (quoting *In re* Eiland, 170 B.R. 370, 379 (Bankr. N.D. Ill. 1994))).

prepetition claims of the municipality's workers and retirees. Although the priority and contribution categories find firm support in the Bankruptcy Code and existing case law, this Article argues that they cannot justify a municipality's decision to provide a greater recovery for retirement claims of active and former workers. The necessity category provides a bit stronger justification for the preference, but it is unlikely that municipalities could offer sufficient proof to justify discriminatory treatment. On the other hand, they may not have to. A court faced with strong political pressure to approve a plan may seize on the necessity argument to justify a departure from the norm of equal treatment. In the final, "other" category, is the argument that considerations of fairness unrelated to those organized under the other categories allow active and former workers better treatment under the plan. The little case law that exists on this matter clearly rejects creditor need as a basis for better treatment, and this Article agrees. Moreover, case law aside, the fairness case for preferring retirees and active workers to other municipal creditors is not compelling.

A. Priority

Part I noted that bankruptcy law frequently departs from the norm of equal treatment by granting some claims priority over others.[120] The pension claims of retirees and active workers do not enjoy a general priority over other unsecured claims.[121] Even the modest wage priority applicable in other bankruptcy chapters does not apply in Chapter 9.[122] If applicable nonbankruptcy law or the funding practices of municipalities were different, retirees and active workers could have priority over general unsecured claims. State statutory liens or trusts could give workers' claims priority with respect to a municipality's tax revenue, and these liens are respected in bankruptcy.[123] The Bankruptcy Code in this case would recognize the priority even with respect to postpetition taxes.[124] Federal and state legislation create statutory trusts in favor of certain beneficiaries,[125] and federal or state law could create

120. *See supra* notes 51–55 and accompanying text.

121. *See* Hynes & Walt, *supra* note 2, at 617–38.

122. *See* 11 U.S.C. § 901(a) (omitting § 507(a)(4)'s provision on wage priority from incorporation into Chapter 9).

123. *See* Hynes & Walt, *supra* note 2, at 649–59.

124. Although § 552 renders a security interest in assets acquired postpetition inoperable unless they are proceeds of existing collateral, the section does not apply to statutory liens. *See* 11 U.S.C. § 552(a).

125. *See, e.g.*, Packers and Stockyards Act, 7 U.S.C. §§ 196, 197 (2012) (requiring packers and live poultry dealers to maintain a statutory trust for the benefit of unpaid sellers or poultry growers); Perishable Agricultural Commodities Act, 7 U.S.C. § 499e(c)(2) (establishing a statutory trust for the benefit of all unpaid suppliers or sellers of perishable agricultural

statutory trusts or liens in favor of state employees. Neither has done so. Alternatively, the municipality could have fully funded the workers' benefits and either granted the workers a security interest in the funds or placed the funds in a separate legal entity against which only the workers have a claim.[126] The workers may be able to use this theory to claim priority with respect to the funds that have been set aside.[127] However, bankrupt municipalities have drastically underfunded their retirement obligations.[128] Other claims of worker priority are equally unavailing. Although supporters of higher recovery rates for retirees and active workers sometimes cite state constitutional provisions that limit the impairment of pension rights, the provisions merely confer on pensions contract rights with the same priority as under other contracts, including municipal bonds.[129]

In Detroit's bankruptcy, Judge Rhodes cited Michigan's constitutional protection of pensions to justify the plan's preferential treatment of Detroit's workers and retirees.[130] First, although he restated his view that the state constitutional provision has no effect in bankruptcy, he considered it an expression of the "considered judgment of the people of the State of Michigan. . . . that is entitled to substantial consideration and deference."[131] Second, Judge Rhodes believed that this constitutional provision gives Detroit's workers and retirees a reasonable expectation of preferential treatment in bankruptcy and that this expectation should be honored.[132] Both arguments are inconsistent with his earlier finding that the protections afforded to pensions under Michigan's constitution merely afforded them the same protection afforded to all other contracts and did not give pensions any "extraordinary protection."[133] If, under the Michigan Constitution, pension

commodities or products); MINN. STAT. § 27.138 (2012) (Wholesale Produce Dealers' Trust) (holding the produce and products of produce of a wholesale produce dealer and proceeds in trust for the benefit of unpaid sellers).

126. For evidence that municipalities have not fully funded their pensions, see Novy-Marx & Rauh, *supra* note 1, at 1213–14, 1239.

127. *See, e.g.*, David A. Skeel, Jr., *Can Pensions Be Restructured in (Detroit's) Municipal Bankruptcy?* 10 n.27 (Federalist Soc'y, White Paper Series No. 508, 2013), *available at* http://scholarship.law.upenn.edu/faculty_scholarship/508/ (conceding that strictly speaking, the pensioners do not hold secured claims against the municipality, but concluding that it is "almost certain[]" that a bankruptcy court would consider the pensioners' claims to be secured).

128. *See* Novy-Marx & Rauh, *supra* note 1, at 1213–14, 1239.

129. *See* Hynes & Walt, *supra* note 2, at 641–43 (citing, *inter alia*, *In re* City of Detroit, 504 B.R. 97, 127 (Bankr. E.D. Mich. 2013)).

130. *See* Detroit Supplemental Opinion, *supra* note 5, at 10, 176–77.

131. *Id.* at 177.

132. *Id.*

133. *In re City of Detroit*, 504 B.R. 97, 150–54 (Bankr. E.D. Mich. 2013).

rights are contractual rights,[134] then Michigan's constitution does not express a preference for paying pensions before other obligations, and any expectation of priority would be unreasonable. Moreover, as we argue below, it is highly unlikely that Congress intended to authorize a judge (or state legislature) to make categorical judgments about the relative priority of creditors such as workers and general creditors.[135]

B. Contribution

Courts sometimes allow the plan to provide a greater recovery for some claims because the holder of these claims contributes something to the reorganization.[136] The logic is that the additional recovery is not really on account of the claim but rather serves as consideration for the contribution.[137] In these cases, the plan does not discriminate in favor of the claim; it discriminates in favor of the contribution, which is unobjectionable. It is easy to see how one could use this argument to justify a greater recovery for at least some active municipal workers. These workers will contribute their labor to the municipality after the bankruptcy filing. The city can pay the workers with wages, new pensions, and other postbankruptcy employee benefits. However, the other claimants should not object if the municipality structures the workers' compensation so that some of it is received as a repayment of prebankruptcy claims. At least, they should not object as long as the total value of the compensation is commensurate to the workers' contribution or the market cost of acquiring replacement labor.

The problem with the contribution justification is that the greater recovery received by many active and former workers will vastly exceed the contribution they make to the municipality's recovery. This is certainly true of the retirees, as they contribute nothing to the city's reorganization; they have retired. Many active workers will also retire very soon, making it implausible that the greater recovery they receive is reasonable when "measured by the services rendered."[138] In short, the contribution argument could, in theory, justify a narrowly tailored program that favored specific workers likely to stay with the municipality for a considerable period of time and work for below market wages and benefits. It cannot justify the favorable treatment actually proposed by bankrupt municipalities.

134. *Id.* at 150.
135. *See infra* notes 189–202 and accompanying text.
136. *See supra* notes 66–82 and accompanying text.
137. *See* Am. United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 148 (1940).
138. *Id.* at 148.

C. *Necessity*

Although municipal debtors cannot justify a greater recovery for retirees with a contribution argument, they may be able to make a necessity argument. They would argue that the municipality needs the goodwill and cooperation of its active and future workers, and the municipality must purchase this goodwill by repaying the retirees. In other words, they would argue that active and future workers would be reluctant or unwilling to work for a municipality that breaks promises to its workers.

While this necessity argument is theoretically plausible, it is unlikely that a bankrupt municipality could actually demonstrate the requisite necessity. Courts should require substantial proof of the relevant reluctance before crediting a necessity argument. Otherwise, the argument is too malleable. Just as a municipality can advance a vague claim of necessity for paying its workers more than other creditors, it could advance similar vague claims of necessity for paying any of its other creditors more than the workers. For example, a city may argue that it is necessary to pay its bonds in full so that it can access capital markets in the future. The argument is initially implausible, because municipalities in bankruptcy have been able to obtain exit financing without proposing to pay defaulted debt in full.[139] Cases in which courts credit an allegation of necessity based on a bare assertion make bad law.[140]

As noted above, at least the Seventh Circuit insists that "the record show[] that the classification [and discrimination] would produce some benefit for the disfavored creditors."[141] In cases that allow discrimination on the grounds of necessity, courts require that no plan of reorganization could have been confirmed without the discrimination.[142] If the plan is proposed in a Chapter 11 or 13 case, the disfavored creditors therefore benefit only if they get more than what they would have received were the estate liquidated in

139. *See* Matt Helms & Brent Snavely, *Detroit Secures $275 Million in Bankruptcy Exit Financing*, DETROIT FREE PRESS (Aug. 28, 2014, 7:28 PM), http://www.freep.com/story/news/local/michigan/detroit/2014/08/28/detroit-secures-275-million-in-bankruptcy-exit-financing-/14754321/; Shelly Sigo, *Jefferson County Details $1.7B Bankruptcy Exit Deal*, BOND BUYER (Nov. 1, 2013, 2:27 PM), http://www.bondbuyer.com/issues/122_212/jefferson-county-details-17b-bankruptcy-exit-deal-1056996-1.html.

140. *See In re* Kmart Corp., 359 F.3d 866, 868–69 (7th Cir. 2004) (describing the lower court's critical vendor order issued in response to allegations of necessity).

141. *Id.* at 874 (citing *In re* Crawford, 324 F.3d 539 (7th Cir. 2003)).

142. *See In re* Hyatt, 509 B.R. 707, 716 (Bankr. D.N.M. 2014) (quoting *In re* Greate Bay Hotel & Casino, Inc., 251 B.R. 213, 228 (Bankr. D.N.J. 2000)); Creekstone Apartments Assocs., L.P. v. Resolution Trust Corp. (*In re* Creekstone Apartments Assocs., L.P.), 168 B.R. 639, 645 (Bankr. M.D. Tenn. 1994) (citing and relying on *In re* Creekside Landing, Ltd., 140 B.R. 713 (Bankr. M.D. Tenn. 1992), and *In re* Aztec Co., 107 B.R. 585 (Bankr. M.D. Tenn. 1989)); *In re* Richard Buick, Inc., 126 B.R. 840, 852 (Bankr. E.D. Pa. 1991).

Chapter 7. The "best interests of the creditors" test that applies in Chapters 11 and 13 already guarantees disfavored creditors this amount.[143] This is because the test sets a liquidation floor. Thus, there is no need to test unfair discrimination in Chapters 11 or 13 by what the disfavored creditors would receive in a Chapter 7 liquidation.[144]

The analysis in Chapter 9 is more complicated. Although a Chapter 9 debt adjustment plan cannot be confirmed unless it is in the best interest of the creditors,[145] Congress did not specify the standard of best interests in that chapter. A liquidation floor is inapplicable in Chapter 9, since municipalities are ineligible for Chapter 7 relief and cannot be liquidated.[146] "Best interests of the creditors" in Chapter 9 could be interpreted to mean that an individual creditor can demand at least as much as it would have received if the case had been dismissed and it had enforced its claim against the municipality.[147] But courts interpret the phrase to state a collective test.[148] Under this test, a plan is in the best interests of the creditors if it gives the group at least the amount that they would receive were the municipality to undertake to make reasonable efforts to repay them.[149] If "best interests of the creditors" states the collective

143. *See* 11 U.S.C. §§ 1129(a)(7), 1325(a)(4) (2012).

144. In theory, one could extend the necessity argument to a case in which the debtor could approve a plan of reorganization that did not discriminate among creditors, but that discrimination allows for an alternative plan with a much greater total distribution. For example, assume that a firm must provide a creditor with favorable treatment if it is to continue its most important product line. This discrimination may not be necessary for a reorganization; the firm could continue with its remaining product lines, but the reorganized firm may be much more profitable if it can discriminate. If a court were to extend the necessity justification to such a case, it is not enough to ensure that the disfavored creditors receive at least as much as they would have received in a liquidation. They should receive at least as much as they would have received in the alternative plan of reorganization. One could extend the same argument to Chapter 9; if courts use necessity to justify discrimination that is not actually necessary to approve any plan of reorganization, they should ensure that the disfavored creditors receive at least as much as they would in an alternative feasible plan that did not discriminate.

145. *See* 11 U.S.C. § 943(b)(7).

146. *See id.* § 101(41) (excluding governmental units from the definition of person); *id.* § 109(a) (limiting Chapter 7 to "persons").

147. *See* 6 COLLIER ON BANKRUPTCY, *supra* note 50, ¶ 943.03[7][a], at 943-25 to -27 (stating that the concept should mean that creditors receive more under the plan than under the alternative they have, where the alternative is dismissal of the case); *cf.* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 515–16 (1942); Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513, 534 (1936) (Cardozo, J., dissenting) (describing debt collection from a municipality outside of bankruptcy).

148. *See, e.g.*, Detroit Supplemental Opinion, *supra* note 5, at 103 ("Under this language, the question is whether the plan is in the best interests of creditors as a whole.").

149. *See In re* Pierce Cnty. Hous. Auth., 414 B.R. 702, 718 (Bankr. W.D. Wash. 2009); *In re* Mount Carbon Metro. Dist., 242 B.R. 18, 34 (Bankr. D. Colo. 1999); 6 COLLIER ON BANKRUPTCY, *supra* note 50, ¶ 943.03[7][a], at 943-25 to -27; *cf. In re* Connector 2000 Ass'n,

test, courts applying the unfair discrimination standard in Chapter 9 need to ask whether the disfavored creditors as a group received more than they would receive compared to a specified floor. A plausible floor is dismissal: discrimination is fair only if the plan gives each disfavored creditor at least as much as it would receive had the Chapter 9 case been dismissed and it had enforced its claim against the municipality.[150]

Given that some of the disfavored claims in large municipal bankruptcies are to receive a return that is effectively zero,[151] it is hard to imagine that the discrimination helps them. In addition, the debtor should have to show that the discrimination is actually necessary to secure the goodwill and effort of future workers, and that those workers who refused to work for a municipality that failed to pay its retirees could not be replaced. A municipality is unlikely to be able to make these showings. Active and future workers may be reluctant to work for a municipality that failed to honor its commitment to pay retirees the amounts promised to them just as suppliers may be reluctant to deliver goods to a company that failed to pay its trade creditors in bankruptcy. However, a municipality could allay the fears of the active and future workers that their pensions will also be at risk either by fully funding their pensions or contracting with a third-party insurance company so that the pensions are not obligations of the city at all.[152] These strategies are likely to be costly, but, given the amount owed to existing retirees, it is highly unlikely that they would be more costly than promising to pay retirement benefits in full.[153]

D. Other Considerations

Most commentators who contend that retirees and active workers should recover more than other claimants argue that given their diminished financial circumstances, the workers deserve the greater recovery in light of their past

---

447 B.R. 752, 766 (Bankr. D.S.C. 2011) (holding that a plan is in the best interests of creditors when, *inter alia*, it gives them the greatest economic return from the debtor's assets).

150. The same policy justifications that lead some courts to understand the "best interests of creditors" standard as stating a collective test are likely to cause them to resist a dismissal baseline for the unfair discrimination test.

151. *See, e.g.*, Franklin Summary Objection, *supra* note 26, at 15 (referring to the city's "*de minimis* payment" as "not reasonable").

152. Private firms are increasingly transferring their pension obligations to third-party insurance companies. *See, e.g.*, Tony Avella, *Workers' Pensions Are At Risk*, TIMESUNION.COM (Oct. 10, 2014, 10:05 AM), http://www.timesunion.com/opinion/article/Workers-pensions-are-at-risk-4885142.php. Senator Orrin Hatch has introduced legislation that would allow state and local governments to do so as well. *See* Secure Annuities for Employee (SAFE) Retirement Act of 2013, S. 1270, 113th Cong., *available at* http://www.hatch.senate.gov/public/_cache/files/730c41a0-4bc6-48ba-aabf-2075b08a853c/SAFE%20Retirement%20Act%20Summary.pdf.

153. For estimates of the size of state and municipal pensions, see Novy-Marx & Rauh, *supra* note 1, at 1239.

service or need.[154] Desert or need is a matter of fairness broadly understood, and fairness might allow a plan to favor the claims of retirees and active workers over those of other coequal unsecured claimants. For fairness to justify giving favorable treatment to retirees and active workers, two things must be true. First, retirees and active workers must deserve or need a greater recovery than other claimants. Second, the Bankruptcy Code must allow the favorable treatment of a class based on the desert or need of class members, or on another moral basis. Both parts of the justification are unpersuasive. The moral case for favorable treatment based on desert or need is not compelling. Even if the argument were compelling, the Bankruptcy Code does not allow favorable class treatment based on these moral considerations. This Article addresses the two parts of the fairness argument for favorable treatment in reverse order.

1. *Categorical Discrimination and the Unfair Discrimination Standard*

Section 1129(b)(1), applicable in Chapter 9,[155] prohibits unfair discrimination between classes.[156] By implication, § 1129(b)(1) permits fair discrimination between classes. The problem is that the Bankruptcy Code and its relevant legislative history are unclear as to what constitutes fair discrimination.[157] By requiring a court to confirm a plan that does not unfairly discriminate against a rejecting class,[158] the Code seems to invite the court to rely on its own standard of fairness.[159] A court's standard plausibly could be a moral standard based on desert or need. After all, no Code provision instructs the court to rely on a different standard, and desert or need are moral considerations that arguably bear on fair treatment. In addition, reliance on a moral standard does not exceed a court's authority to invoke its equitable

154. *See* Beermann, *supra* note 22, at 1022; Andrew G. Biggs, *The Looting of Detroit's Pensions*, AM. MAG., Feb. 16, 2014, *available at* http://www.aei.org/publication/the-looting-of-detroits-pensions/; *cf.* Andrea Riquier, *Pensions No Sacred Cow in Bankruptcy:* Stockton *Judge*, INVESTOR'S BUS. DAILY (Oct. 2, 2014), http://news.investors.com/politics/100214-720066-pensions-are-no-sacred-cow-in-bankruptcy-judge-says.htm (reporting that in Stockton's bankruptcy, fairness arguments for favorable treatment of pensioners are a strong theme). However, in the Detroit bankruptcy, Judge Rhodes explicitly refused to consider the financial need of the retirees. *See* Detroit Supplemental Opinion, *supra* note 5, at 178.

155. 11 U.S.C. § 901(a) (2012).

156. *Id.* § 1129(b)(1).

157. *Cf.* H.R. REP. NO. 95-595, at 417 (1977), *reprinted in* 1987 U.S.C.C.A.N. 5963, 6373 ("The criterion of unfair discrimination is not derived from the fair and equitable rule or from the best interests of creditors test. Rather it preserves just treatment of a dissenting class from the class's own perspective.").

158. *See* 11 U.S.C. § 1129(b)(1).

159. *See* Detroit Supplemental Opinion, *supra* note 5, at 175.

powers to "carry out" the Code's provisions.[160] Section 1129(b)(1) requires the court to vet a plan for unfair discrimination, and consulting its own moral standards of fairness seemingly fulfills the requirement.

However, closer scrutiny suggests that general moral considerations based on desert or need cannot properly inform the Code's unfair discrimination standard. To date, courts have not determined the fairness of favorable treatment based on moral bases such as a creditor's desert or its need. In fact, cases state that favorable treatment cannot be based on a creditor's status or the terms of its claim.[161] A reasonable inference from these cases is that a creditor's desert or its need also does not make favorable treatment of the creditor fair. A strong argument supports this proposition. The Code recognizes certain nonbankruptcy priorities and in a few instances creates others.[162] Allowing a plan to favor a class of creditors over another coequal class in effect gives the favored class priority. Because favorable treatment based on generally applicable moral considerations upsets priorities set by the Code, they cannot inform the fair-discrimination standard. Otherwise, these standards effectively supplant priorities decided on by Congress with a court's own scheme of priorities.

The comparison with the Code's grant of the power of equitable subordination is close. The power allows a court to subordinate a creditor's claim to another claim or an interest.[163] An unsubordinated claim or interest effectively has priority over the subordinated claim: it is satisfied in whole or part before the subordinated claim receives anything.[164] Subordination and fair discrimination both upset priorities established by the Code. The Code puts limits on the power of equitable subordination, and the Supreme Court has added an additional limit: equitable subordination must be based on "principles of equitable subordination,"[165] not on any consideration that seems equitable to a court. In addition, the Supreme Court allows subordination only on the basis of the equities of the particular case.[166] This limit prevents a court from subordinating a claim based solely on its priority status. A similar limitation prevents courts from favoring the claims of active and retired workers based on moral standards that are unrelated to the particular circumstances of these claimants.

---

160. *See id.* § 105(a).

161. *See supra* notes 117–19 and accompanying text.

162. *See supra* notes 52–56 and accompanying text.

163. *See* 11 U.S.C. § 510(c).

164. *See* DAVID G. EPSTEIN ET AL., BANKRUPTCY § 6-93, at 437 (1992).

165. 11 U.S.C. § 510(c)(1).

166. *See* United States v. Noland, 517 U.S. 535, 543 (1996) ("We do hold that . . . the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the Code.").

Because bankruptcy courts draw an analogy between unfair discrimination and equitable subordination,[167] it is useful to consider the Supreme Court's logic in an important equitable-subordination case, *United States v. Noland*.[168] *Noland*'s logic suggests that a court cannot approve a plan that gives more to the claims of retirees and active workers merely because these claimants are generally more deserving or needy than other claimants. In *Noland*, the lower courts equitably subordinated a claim for a tax penalty.[169] The lower courts reasoned that, although the tax penalty would ordinarily have priority over general unsecured claims as an administrative expense,[170] general bankruptcy policy favors pecuniary losses over penalties.[171] Like "unfair discrimination," the power of equitable subordination seemed to these courts to allow a court to use its own sense of fairness or equity to subordinate a claim for a tax penalty.[172] The Supreme Court disagreed.[173]

The Court began by noting that the doctrine of equitable subordination predated its inclusion in the Code and that "[t]he normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications."[174] The Court then noted that prior to the adoption of the Code courts generally required that the subordinated party have engaged in inequitable conduct, that the inequitable conduct injured the other creditors or conferred an unfair advantage on the subordinated party, and that the subordination "not be inconsistent with the provisions of the Bankruptcy Act."[175] Acknowledging that Congress may have intended to "give courts some leeway to develop the doctrine,"[176] the Court ultimately refused to decide whether equitable subordination required a showing of inequitable

167. *See, e.g.*, *In re* Chapman, 146 B.R. 411, 418 (Bankr. N.D. Ill. 1992) ("What the debtor would be doing is equitably subordinating 90% of the claims of those creditors holding dischargeable claims to the nondischargeable student loans.").

168. *Noland*, 517 U.S. 535.

169. *See In re* First Truck Lines, Inc., 141 B.R. 621, 629 (Bankr. S.D. Ohio 1992), *aff'd sub nom.* IRS v. Noland, 190 B.R. 827, 830 (S.D. Ohio 1993), *aff'd sub nom.* United States v. Noland (*In re* First Truck Lines, Inc.), 48 F.3d 210, 218 (6th Cir. 1995), *rev'd*, *Noland*, 517 U.S. 535.

170. *See* 11 U.S.C. §§ 503(b)(1)(C), 507(a)(2).

171. *See* cases cited *supra* note 169.

172. *Noland*, 517 U.S. at 538

173. *Id.*

174. *Id.* at 539 (quoting Midlantic Nat'l Bank v. N.J. Dep't of Envtl. Prot., 474 U.S. 494, 501 (1986)).

175. *Id.* at 538–39.

176. *Id.* at 540.

conduct.[177] It did not need to do so because it found it "improbable in the extreme" that Congress intended to deviate from this rule and allow courts to subordinate claims at a categorical level.[178] If the provision allowed a court to subordinate taxes at a categorical level, "it would empower a court to modify the operation of the priority statute at the same level at which Congress operated when it made its characteristically general judgment to establish the hierarchy of claims in the first place."[179] In other words, "the distinction between characteristic legislative and trial court functions would simply be swept away, and the statute would delegate legislative revision, not authorize equitable exception."[180]

The Supreme Court's logic in *Noland* suggests that courts cannot properly use the unfair discrimination standard to favor an entire category of claims, such as those of active and former workers. Its rationale for barring categorical subordination also bars categorical discrimination. Giving courts the power to discriminate without regard to the particular circumstances of the favored creditor class effectively alters the Code's established priorities. Congress might have wished to grant courts some leeway to develop the unfair discrimination standard, but it is implausible that Congress intended to grant courts the power to discriminate between creditors on a categorical basis. Like equitable subordination, unfair discrimination requires the showing of an additional element particular to an individual creditor.[181] While equitable subordination arguably requires proof of inequitable conduct, unfair discrimination requires a showing of contribution by members of the favored class or a demonstration that discrimination is necessary to the reorganization.[182] *Noland*'s rationale does not allow a plan to favor a class solely because its members are retirees or active workers.

A court's vague disclaimer that it is not engaged in categorical discrimination does not establish that a plan's favorable treatment of workers is fair. In *Noland*, the lower courts tried a similar tack with respect to equitable subordination.[183] The Supreme Court rejected the approach of the lower courts:

177. *See id.* at 543.

178. *Id.* at 540–41.

179. *Id.* at 540.

180. *Id.*

181. *See In re* Monroe, 281 B.R. 398, 399 (Bankr. N.D. Ga. 2002) (standing for the proposition that courts generally consider facts and circumstances to determine unfair discrimination); *In re* Aztec Co., 107 B.R. 585, 589 (Bankr. M.D. Tenn. 1989) (same).

182. *See supra* notes 29–119 and accompanying text.

183. *See Noland*, 517 U.S. at 541.

> [A]lthough the court said that not every tax penalty would be equitably subordinated, that would be the inevitable result of consistent applications of the rule employed here, which depends not on individual equities but on the supposedly general unfairness of satisfying "postpetition, nonpecuniary loss tax penalty claims" before the claims of a general creditor.[184]

In other words, a court could not properly reason that active and former workers, as a group, are more deserving of recovery than general creditors.[185] This categorical subordination is inherently legislative in nature. Congress has explicitly granted some worker claims priority over general unsecured claims,[186] but has chosen not to make this priority applicable in Chapter 9 or extend it to retirement claims.[187] Therefore, creating a judicial priority for retirement claims is inconsistent with the Code.

A court may, however, engage in truly individualistic reasoning, relying on findings about the particular circumstances of a municipality's workers. For example, it could collect data on their other sources of income and wealth as well as their prospects for other employment. Based on the particular financial circumstances of class members, the court could conclude that the plan's favorable treatment of the class is fair. *Noland* left unaddressed the question of whether Congress intended to allow courts to equitably subordinate claims without a showing of inequitable conduct.[188] A similar question remains with respect to the unfair discrimination standard: does the unfair discrimination standard allow a plan to favor a class solely on the basis of the status or financial circumstances of its members? The Court could allow the use of the unfair discrimination standard to favor workers or particularly needy creditors, but doing so would radically change the existing law.

2. *Fair Treatment*

Commentators who believe that the Code permits reorganization plans favoring retirees and active workers must believe that the favorable treatment is fair. Fairness is a broad moral category, which includes desert and need.[189]

---

184. *Id.* (internal citations omitted).

185. *See id.*

186. *See* 11 U.S.C. § 507(a)(4) (2012); *id.* § 901(a) (providing that § 507(a)(4) is inapplicable in Chapter 9).

187. *See id.* § 507(a)(4) (providing no provision for retirement claims); *id.* § 901(a) (providing that § 507(a)(4) is inapplicable in Chapter 9).

188. *Noland*, 517 U.S. at 543.

189. *Cf.* SHELLY KAGAN, NORMATIVE ETHICS 54–59 (1998) (describing fairness as somewhat of an amorphous notion); LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 38–39 (2002) (stating that fairness includes justice and related concepts, such as rights).

Accordingly, it might be argued that fairness permits or perhaps requires giving retirees and active workers favorable treatment because they deserve or need it. Retirees and active workers have contributed services to the municipality and deserve to have their claims satisfied in light of their contribution. In addition, given their modest financial position, retirees and active workers more urgently need to have their claims satisfied than other creditors. Desert or comparative need therefore make it fair for the plan to favor them over the municipality's other coequal creditors.

This fairness case for favorable treatment based on desert or need is not conclusive. First, consider desert. Contribution arguably is a basis for deserving a benefit.[190] Contribution, however, is not sufficient for favorable treatment. This is because there might be others who also deserve the same benefit in light of their own contributions. Although retirees and active workers might deserve payment of their claims based on their past services, bondholders and other contract creditors also have contributed to the municipality's continued operations. They also deserve to have their claims satisfied based on their contribution of capital, assets, or services. Thus, retirees and active workers deserve better treatment only if their contribution makes them more deserving of payment than the municipality's other creditors.

It is hard to see how, in the abstract, retirees and active workers might be more deserving of payment than other contract creditors simply in light of their previous contributions to the municipality's continued operations. There are in fact two problems here. First, it is not apparent that retirees and active workers deserve favorable treatment at all. Both workers and other contract creditors have contributed to the municipality's operations, and there is no reason a priori why one sort of contribution makes the contributor more

190. *See, e.g.*, Julian Lamont, *The Concept of Desert in Distributive Justice*, 44 PHIL. Q. 45, 60 (1994); *cf.* DAVID MILLER, MARKET, STATE, AND COMMUNITY 159 (1989). In the text, we assume that contribution is a possible basis for moral desert. The literature frequently distinguishes between moral desert and other forms of desert, such as economic desert. *See, e.g.*, Thomas Hurka, *Desert: Individualistic and Holistic*, *in* DESERT AND JUSTICE 45, 57–59 (Serena Olsaretti ed., 2003). This distinction makes contribution potentially relevant to economic desert, not to moral desert. Given the divide, the deserved distribution of assets on account of contribution fits under economic desert. For purposes of argument, we consider contribution a possible basis for moral desert. Although a large topic, the frequently drawn distinction between moral and economic desert marks a difference in both the basis of desert (e.g., virtue versus contribution) and what is deserved (e.g., well being versus income or compensation). The unfair discrimination standard allows a plan's proposed distribution to favor a class only if the distribution is fair. Whether the distribution is fair in turn is a matter of morality in a recognizable sense. For this reason, we suppose that contribution can be a basis for moral desert that makes favorable treatment fair. For the assertion that past service makes retirees deserving of full payment of their pensions, see Biggs, *supra* note 154.

deserving of payment than the other. Both groups of contributors deserve payment. The trouble is that the insolvent municipality's plan proposes to distribute to classes amounts less than the class members are owed. As a result, paying a particular creditor class more means paying another class less. Because plan assets are scarce, the treatment that one class deserves depends on the treatment another class deserves.[191] Thus, retirees and active workers deserve a greater payout only if other contract creditor classes deserve a lower payout. The second problem is that it is unclear how much favorable treatment is deserved, even if retirees and active workers are more deserving than other contract creditors. For example, creditor *A* might be slightly more deserving than creditor *B*. Still, desert might not allow paying *A* in full while paying *B* nothing. Detroit's bankruptcy plan proposes to pay in full the pension claims of the police and firemen, while paying 15% of the claims of city vendors with contract claims.[192] Without a metric of deserved treatment, the fairness of a plan's favorable treatment cannot be determined. Given both problems, the case for favorable treatment based on desert has not been made.

In Detroit's bankruptcy the court relied in part on morality to determine the fairness of discrimination under § 119(b)(1). It found that fairness requires resort to the court's "conscience," which is informed by the court's experience and morality.[193] According to Judge Rhodes, the city's mission is to provide municipal services to residents and visitors, and the city's retirees and active workers are part of the "backbone" of the structures that fulfill the city's mission.[194] The court concluded that the city's interest in maintaining its relationships with active workers, and attracting new workers, makes the plan's discrimination in favor of pension claims fair.[195] This moral rationale for discrimination is odd, as it is based neither on necessity nor contribution. It is not based on necessity, because Judge Rhodes offered no evidence that the discrimination was needed to attract a work force. He did not consider whether Detroit could have used other, cheaper, means of preserving its relationship with its existing employees and motivating and attracting skilled new employees. Contribution also is absent because retirees, by assumption, are not in a position to contribute to the structures that supposedly fulfill the

191. *See* Shelly Kagan, *Equality and Desert*, *in* WHAT DO WE DESERVE? 298, 301–13 (Louis P. Pojman & Owen McLeod eds., 1999) (discussing notions of comparative desert); Thomas Hurka, *The Common Structure of Virtue and Desert*, 112 ETHICS 6, 30 n.25 (2001).

192. Corrected Fifth Amended Plan for the Adjustment of Debts of the City of Detroit at 36–38 (Class 10), 42 (Class 14), *In re* City of Detroit, No. 13-53846 (Bankr. E.D. Mich. July 29, 2014), *available at* http://www.detroitmi.gov/Portals/0/docs/EM/Bankruptcy%20Information/6381.pdf.

193. *See* Supplemental Opinion, *supra* note 5, at 175.

194. *See id.* at 176.

195. *See id.*

city's mission. At bottom, the court's conclusion rests on an undefended intuition that morality allows discrimination in favor of pension claims.

Now consider need. A plausible view of fairness is that it requires giving priority to those who are worse off. One way of understanding the view is that the well being of those who are worse off has greater weight than the well being of those in a better position.[196] The basic idea is that benefitting people is morally more important, the worse their position.[197] In short, there is a stronger reason to benefit people the worse off they are. Their comparatively poor position makes satisfaction of their needs morally more urgent.[198] This conception of fairness could justify giving retirees and active workers favorable treatment under the plan. If the financial position of retirees and active workers is inferior to that of other creditors, and satisfying their claims against the municipality avoids making their financial position worse, their claims have more weight than other creditors' claims.[199] There is, therefore, a stronger reason to benefit retirees and active workers than there is to benefit the municipality's other creditors. Accordingly, a plan that favors their claims is fair.

The fairness case for favoring retirees and active workers based on comparative need is not compelling. Even if the operative view of fairness is unproblematic, there are problems with its application. For one thing, individual retirees and active workers differ in their financial circumstances, according to the length of their job tenure, their investments, and their opportunities for alternative employment. The variance in the financial positions of members within a class of retirees or active workers likely will be considerable. As a result, the proper weight given to the claims of class members will differ, so that a plan's favored treatment of the class could be fair with respect to some class members and unfair with respect to others. Thus, it cannot safely be concluded that fairness allows the plan to favor retirees and active workers as a group.

Moreover, it is unclear that retirees and active workers are in an inferior financial position to other creditors. Municipalities usually have many

---

196. *Cf.* THOMAS NAGEL, EQUALITY AND PARTIALITY 65–69 (1991); T. M. SCANLON, WHAT WE OWE TO EACH OTHER 223–29 (1998) (describing this principle of morality); LARRY S. TEMKIN, INEQUALITY 245–48 (1993) (describing a principle of benevolence independent of equality); Derek Parfit, *Another Defense of the Priority View*, 24 UTILITAS 399, 401 (2012) (describing such a principle of equality); Derek Parfit, *Equality and Priority*, 10 RATIO 202 (1997) (describing a principle of equality and utility).

197. *See* NAGEL, *supra* note 196, at 66; Parfit, *Equality and Priority*, *supra* note 196, at 212–13.

198. *See* THOMAS NAGEL, MORTAL QUESTIONS 123–24 (1991).

199. *See* Beermann, *supra* note 22, at 1020 (relying on this sort of claim in his conclusion that local pension cuts risk placing older Americans into poverty).

creditors, including tort creditors and different types of contract creditors.[200] A tort creditor who is an individual might be in a worse financial position than the municipality's retirees and workers. Similarly, although bondholders might be in better financial circumstances than retirees and current workers because they are wealthier or hold better-diversified investment portfolios, the same need not be true of other contract creditors. And beyond the municipality's creditors are employees of these creditors. These employees might be in a worse financial position than the municipality's workers, who enjoy more generous salaries and retirement benefits. A failure of the municipality's plan to favor creditors employing them could force the creditors to cease operations or reduce their own labor force. Bankruptcy law takes into account only the interests of those holding claims against the debtor.[201] Morality, however, considers the impact of a distribution of assets on those in poor financial positions, even if they are not creditors of the debtor.[202] Thus, fairness requires taking into account the comparatively inferior position of these employees to give greater weight to the claims of their employers against the municipality. For these reasons, the argument for favoring retirees and active employees based on comparative need is not established.

III. EVADING THE UNFAIR DISCRIMINATION STANDARD

Section II looked at whether a court could approve a plan providing a municipality's active workers and retirees a greater recovery than general unsecured creditors if a class of these general unsecured creditors rejected the plan and raised an unfair discrimination objection. This Section discusses whether a municipality could prevent the disfavored creditors from raising this objection.

---

200. Detroit's debt adjustment plan creates seventeen classes of creditors. Fifth Amended Plan for the Adjustment of Debts of the City of Detroit at 28–29, *In re City of Detroit*, No. 13-53846 (Bankr. E.D. Mich. July 25, 2014), *available at* http://www.detroitmi.gov/Portals/0/docs/EM/Bankruptcy%20Information/6257.pdf. Approximately 33,000 individuals who participate in Detroit's pension plans have claims against the city. *See* Disclosure Statement With Respect to Plan for the Adjustment of Debts of the City of Detroit at 4, *In re City of Detroit*, No. 13-53846 (Bankr. E.D. Mich. Feb. 21, 2014), *available at* http://www.detroitmi.gov/Portals/0/docs/EM/Bankruptcy%20Information/Disclosure%20Statement%20_Plan%20for%20the%20Adjustment%20of%20Debts%20of%20the%20City%20of%20Detroit.pdf.

201. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 13–19 (1986) (clarifying that bankruptcy law does and should replace rules for individual debt collection with collective debt-collection rules).

202. *See supra* note 189 and accompanying text.

A. Claim Classification and Class Rejection

A plan proponent may be able to prevent creditors from raising an unfair discrimination objection. To do so, the plan must put claims held by creditors likely to reject the plan into a class of claims that will vote to accept it. Under both Chapters 9 and 11, classes of claims vote on a plan by a dual voting rule.[203] A class of claims accepts the plan if both a simple majority of claims voted and more than two-thirds in amount of voted claims vote to accept it.[204] Otherwise, the class has voted to reject the plan. As a result, even if a creditor votes its claim to reject the plan, the class has accepted the plan if more than half of the claims voted and more than two-thirds in amount of voted claims voted to accept it. Section 1129(b)(1)'s cramdown provision allows confirmation over the objection of a rejecting class only if the plan does not unfairly discriminate with respect to that class.[205] The same restriction applies in Chapter 9.[206] Thus, only claims in rejecting classes can object that the plan unfairly discriminates against them. Rejecting members of an accepting class have no standing to raise the unfair discrimination objection to reorganization plans in Chapters 9 and 11.[207]

Accordingly, the plan can mute the voice of rejecting claims by putting them in a class of claims that reliably will vote to accept the plan. This strategy assures that the class will accept the plan and the unfair discrimination standard will not be applied to the plan's treatment of that class. Predictably, rejecting members of accepting classes objecting to their treatment under the plan will object to the classification of their claims. They will make a three-step argument in support of their objection. First, the rejecting class members will argue that their claims are improperly classified

203. *See* 11 U.S.C. § 1126(c) (2012); *id.* § 901(a) (incorporating § 1126(c) into Chapter 9).

204. *Id.* §§ 901(a), 1126(c). If the plan promises nothing of value to a class, § 1126(g) deems the class to have rejected the plan and solicitation of the class's vote is unnecessary. *Id.* § 1126(g).

205. Section 1129(b)(1) also limits absolute priority rule objections to claims or interests in classes that have rejected the plan. *See id.* § 1129(b)(1); *see also* H.R. REP. NO. 95-595, at 413 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6369.

206. *See* 11 U.S.C. § 901(a) (incorporating § 1129(b)). The class-based restriction is not accidental. Under § 1325(b)(1), an individual creditor has the right to raise the objection of unfair discrimination with respect to its claim. Congress elected not to import an individual-based restriction into Chapters 9 and 11. *Id.* §§ 901(a), 1129(b)(1), 1325(b)(1).

207. *See id.* § 1129(b)(1) (applying the unfair discrimination standard only "with respect to each class of claims or interests that is impaired under, and has not accepted, the plan"); *id.* § 901(a) (incorporating § 1129(b)(1)); *see also In re* City of Colo. Springs Spring Creek Gen. Improvement Dist., 187 B.R. 683, 690 (Bankr. D. Colo. 1995) (holding that a dissenting creditor was bound to the class's vote because Chapter 9 provided no recourse).

with other claims in the class.[208] Second, they will urge that, had their claims been properly classified, the class of which they were members would have voted to reject the plan. Third, they will argue that the plan unfairly discriminates (or would do so) against that rejecting class.

Because the unfair discrimination standards of Chapters 9 and 11 are class-based, the most important step in the argument is the first: that the plan improperly classifies the rejecting class members' claims.[209] If the classification of their claims is proper, the rejecting members have no right to object that their treatment under the plan unfairly discriminates against them. The rest of the argument, therefore, would fail. Unlike the unfair discrimination standard, relevant Code provisions do not limit the parties who may object to a classification of claims.[210] Thus, any party in interest has standing to contest the classification of claims in a class. A member of an accepting class of claims may therefore object to the classification of its claim even if it cannot object to the treatment of the claim under the plan as unfair.

The Bankruptcy Code's regulation of claim classification is incomplete, and courts are divided on the issue. The Code clearly prohibits the plan from placing claims with substantially different legal rights in the same class.[211] It allows the plan to put small claims into separate classes when done for administrative convenience,[212] even when the claims are substantially similar.[213] However, the Code, says nothing about the permissibility of putting other substantially similar claims into different classes. A minority of cases require that claims having the same legal character be put in the same class.[214] Most courts permit the plan to classify similar claims separately as long as there is a legitimate business justification or "reasonable basis" for

208. *See, e.g.*, 11 U.S.C. § 1122 (providing for classification of claims or interests that are "substantially similar").

209. *Id.*

210. *See, e.g.*, *id.* §§ 1122(a), 1129(a)(1); *cf.* FED. R. BANKR. P. 3013 ("For the purposes of the plan . . . the court may, on motion after hearing . . . determine classes of creditors and equity security holders pursuant to § 1122 . . . .").

211. *See* 11 U.S.C. § 1122(a).

212. *See id.* § 1122(b).

213. *Id.*

214. *See* Barnes v. Whelan (*In re* Barnes), 689 F.2d 193, 201 (D.C. Cir. 1982) (reversing the decision of the lower court, which required all similar claims to be placed in one class); *In re* Perkins, 55 B.R. 422, 424–25 (Bankr. N.D. Okla. 1985) (discussing a Fifth Circuit opinion that allowed separate classification of similar claims, despite the holding's disagreement with other opinions). The pre-Code classification rule under the Bankruptcy Act was the same. *See, e.g.*, *In re* L.A. Land & Invs., Ltd., 282 F. Supp. 448, 453–54 (D. Haw. 1968).

doing so.[215] Although this test does not provide much guidance, cases often recite a slightly more specific rule: "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan."[216] Gerrymandering is fairly easily found if the plan proponent alters the classification of a class in response to a third party's purchase of some of the claims in the class.[217] Its response to the sale suggests that the motive for the initial classification was to engineer the class's vote to accept the plan.[218] In other cases, evidence of the motivation for constructing a class is less clear.

B. Good Faith and Class-Based Standing

A rejecting member of a class that has voted to accept the plan sometimes challenges the plan on grounds independent of the classification of its claim. It objects to the plan on the ground the plan has not been proposed in good faith as required by § 1129(a)(3), also applicable in Chapter 9.[219] Because the class-based standing requirement in § 1129(b)(1) does not apply to § 1129(a)(3), any party in interest may object that the plan was proposed in bad faith. Thus, a rejecting member of an accepting class seemingly may argue that the plan is not offered in good faith because it unfairly discriminates against the class. The contention appears plausible, because the predominant judicial test for the fairness of discrimination includes good faith as a requirement.[220] Nonetheless, the Code's structure suggests that the rejecting member should not be allowed to make this argument. Sections 1129(a)(3) and 1129(b)(1) are separate requirements.[221] If possible, they therefore should be construed so that both are given effect. Allowing the rejecting member of an accepting class to argue that it is bad faith to propose a plan that unfairly discriminates against it effectively eliminates the class-based standing requirement of § 1129(b)(1). It would allow the class member to rehearse its case for unfair discrimination under the guise of good faith. In

---

215. *See* Heartland Fed. Sav. & Loan Ass'n v. Briscoe Enters., Ltd., II (*In re* Briscoe Enters., Ltd., II), 994 F.2d 1160, 1167 (5th Cir. 1993); *In re* Adelphia Commc'ns Corp., 368 B.R. 140, 247 (Bankr. S.D.N.Y. 2007).

216. *See* Travelers Ins. Co. v. Bryson Props., XVIII (*In re* Bryson Props., XVIII), 961 F.2d 496, 502 (4th Cir. 1992); Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274, 1279 (5th Cir. 1991).

217. *See* CWCapital Asset Mgmt., LLC v. Burcam Capital II, LLC, Nos. 5:13-CV-278-F, 5:13-CV-279-F, 2014 U.S. Dist. LEXIS 87900, at *14–15 (E.D.N.C. June 24, 2014).

218. *See id.*

219. 11 U.S.C. § 901(a) (2012).

220. *See supra* note 45 and accompanying text.

221. *See* 11 U.S.C. § 1129(b)(1) ("[I]f all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court . . . shall confirm the plan . . . if the plan does not discriminate unfairly . . . .").

substance, the rejecting class member's objection is one of unfair discrimination. It should be treated as such, and not as an objection based on the plan proponent's good faith.

The unfair discrimination standards under §§ 1129(a)(3) and 1129(b)(1) can both be given effect easily. If the rejecting member of an accepting class's objection to the plan is one of bad faith, unrelated to the fairness of its treatment, the objection is allowable. The rejecting member may raise the objection in its own right, whether or not it is a member of a rejecting class. If, however, the objection alleges bad faith based on the unfairness of treatment under the plan, it is not allowable. Section 1129(b)(1) permits only classes that have rejected the plan to object to their treatment under the plan.

C. *Equal Treatment of Claims in a Class*

This Article argued above that a court should not allow a member of an accepting class to complain that classes of claims with substantially similar legal rights are receiving better treatment.[222] The Code does not recognize an unfair discrimination objection made by a holder of a claim in an accepting class.[223] However, § 1123(a)(4) requires the plan to treat claims in the same class the same way.[224] The equal treatment rule of § 1123(a)(4) allows the holder of a claim in an accepting class to complain that other claims in the class are receiving better treatment.[225] This preferential treatment may explain why the holders of the other claims in the class are voting for the plan.

Consider a hypothetical. Assume that the debtor is a small business that owes $100,000 to each of ten trade creditors, has a liquidation value of $250,000, and a going-concern value of $500,000. The debtor could propose a plan that gives each trade creditor a note with a present value of $50,000, but this would leave no value for the shareholder. Assume instead that the shareholder proposes a plan that places all of the trade creditors in the same class and pays each $25,000, the pro rata share of the firm's liquidation value. The shareholder would retain all of the equity of the firm, in violation of the absolute-priority rule. However, like unfair discrimination, only the holder of a claim that rejects the plan can raise an absolute priority objection.[226] If the shareholder offers sufficiently attractive terms (a "bonus") to the first seven

222. *See supra* notes 219–21 and accompanying text.

223. *See* 11 U.S.C. § 1129(b)(1).

224. *See id.* § 1123(a)(4).

225. *See id.* § 1128(b) (allowing a party in interest to object to the confirmation of the plan); FED. R. BANKR. P. 3017(a) (requiring court to hold a hearing on a disclosure statement at which creditors' objections can be considered); *id.* R. 3020(b)(2) (requiring court to rule on confirmation after notice and hearing of objection to plan).

226. *See* 11 U.S.C. § 1129(b)(2)(B).

trade creditors who commit to supply to the new firm and agree to vote for the plan, she should be able to secure enough votes. A bonus of $26,000 should suffice because it leaves the accepting creditors better off than they would be under the plan with equal treatment, and this bonus would allow the manager to keep $68,000 in equity.[227] The three creditors who were late to respond lose from this arrangement, as their individual recoveries drop by $25,000. A creditor might object that the plan is not proposed in good faith, or that the debtor is not really using the debtor's funds in the ordinary course of business. The better objection, however, is that the plan does not, in fact, treat all claims in the class equally as required by § 1123(a)(4).

As a formal matter, the plan gives each claim the same dividend: $25,000, or 25% of each claim. In substance, however, at least some of this dividend should be attributed to the prebankruptcy claim, violating the equal treatment rule of § 1123(b)(4). Although a search reveals no cases applying this logic to find unequal treatment of claims within a class, courts sometimes look to substance over form to determine the amount that a creditor received on its claim.[228] This is the logic that the Court used in *Avon Park* to hold that the debtor could not prove that the plan did not unfairly discriminate against some creditors.[229] It is also the reasoning that other courts have applied to rule that plans awarding some claims more than other substantially similar claims do not unfairly discriminate because that additional recovery is really on account of some new contribution.[230] For example, some courts have upheld a greater recovery for the holders of a claim when the holder has waived another claim.[231]

227. The accepting creditors are better off because they receive $51,000 (the $25,000 from the plan and the $26,000 bonus) instead of the $50,000 they would receive in a pro rata plan that gave all of the going-concern value to the creditors. The manager can retain $68,000 in equity because the going-concern value is $500,000 and the firm pays a total of $432,000 to creditors ((*7*$51,000*) + (*3*$25,000*) = *$432,000*). The manager may be able to extract much more equity if she can exploit a prisoner's dilemma among the creditors.

228. *See, e.g.*, ACC Bondholder Grp. v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), 361 B.R. 337, 363–64 (S.D.N.Y. 2007) (predicting that different payments contingent on whether class members voted for the plan likely violates § 1123(a)(4)); Finova Grp., Inc. v. BNP Paribas (*In re* Finova Grp., Inc.), 304 B.R. 630, 633–37 (D. Del. 2004) (indicating that some "utilization fees" labeled "interest" were paid while other "utilization fees" labeled "fees" were not paid, and the plan comported with the equal treatment mandate).

229. *See* Am. United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 147–48 (1940).

230. *See, e.g.*, Markell, *supra* note 16, at 255–57.

231. *See, e.g.*, *In re* HRC Joint Venture, 187 B.R. 202, 210–12 (Bankr. S.D. Ohio 1995); *In re* Shadow Bay Apartments, Ltd., 157 B.R. 363, 366 (Bankr. S.D. Ohio 1993) (holding that debtor had not met its burden of proving the absence of unfair discrimination, but not ruling on whether obtaining an offset as an administrative expense could be used as consideration for granting retention of partnership rights to one of two general partners in the debtor business).

There is, of course, the difficult matter of proof and the burden of offering it. In the hypothetical above, this does not matter much because the bargain was explicit. The debtor did not offer a bonus to the first seven trade creditors who agreed to supply goods and services, but explicitly required that they vote in favor of the plan. At least some of the bonus should therefore be attributed to the vote, violating the equal treatment rule. However, a better advised debtor would have dropped the explicit requirement for a vote in favor of the plan, as the favored trade creditors would realize that they could only collect on their contracts if the reorganization plan succeeded. The bargain would be implicit rather than explicit. Although in such cases the allocation of the burden of proof will matter a great deal, it is not insurmountable. If the objecting party bears the burden, it may be able to show an implicit bargain by demonstrating that the trade creditors are receiving substantially above market terms for their goods, even taking into account the risk that they are dealing with a financially weak customer. If the debtor bears the burden of proof, it can show that the terms of the deal are fair.[232]

The next Section discusses *In re City of Stockton*, a recent case that illustrates a real-world example of this argument.

D. *Unfair Discrimination and Classification:* In re City of Stockton

Questions of claim classification are separate from questions of unfair discrimination. The inquiry into proper classification asks whether there is a legitimate reason for putting a claim in a class, while the inquiry into unfair discrimination asks whether the plan's treatment of the class is fair. Nonetheless, creditors objecting to the plan sometimes argue that the plan improperly classifies their claims because it treats the claims unfairly. This objection makes the question of claim classification turn on an inquiry into unfair discrimination. The argument appears in ongoing litigation in *In re City of Stockton*.[233]

Stockton's reorganization plan proposes to pay the pensions of its current and former workers in full while one bondholder, Franklin High Yield Tax-Free Income Fund and Franklin High Yield Municipal Fund (collectively, Franklin), will recover about 0.25% of its unsecured claim ($94,000 of a $35 million claim).[234] Franklin perhaps negotiated aggressively, and the nominal recovery that Stockton's plan offered it might be in retaliation for its hard

232. As a normative matter, it arguably is better to allocate the burden of proof to the plan proponent because the plan proponent has the option of splitting the claims into different classes and relying on the explicit fairness tests.

233. *See* Franklin Summary Objection, *supra* note 26, at 46–51.

234. *See id.* at 3–4, 6–7.

bargaining stance.[235] However, there is a more compelling reason for Stockton to give Franklin at least a nominal amount: creditors who get nothing are conclusively presumed to vote against the plan.[236] Although Franklin voted against the plan, enough other creditors in its class voted for the plan for the class to accept the plan.[237] The other claims in Franklin's class were the healthcare claims held by Stockton's former workers.[238] These claims were valued in a settlement agreement between Stockton and its current and former workers that required 1,100 holders to vote in favor of the plan.[239]

Franklin raised several objections, some of which were based on notions of horizontal equality. It argued that the plan gave the healthcare claims a greater recovery and therefore violated the requirement of equal treatment of claims in the same class.[240] There are two parts to this argument. First, Franklin argued that the plan violated the equal-treatment requirement because it provided the current and former workers with a combined recovery of over 70% while Franklin gets just 0.25% on its claim.[241] Bankruptcy law does not require equal treatment of creditors; rather, it requires equal treatment of claims. Consider a creditor that owed $1 million on a loan secured by a $600,000 building. The Code would divide the loan into a $600,000 secured claim and a $400,000 unsecured claim. If the secured creditor received the same 10% recovery on its unsecured claim as the general unsecured creditors, the general unsecured creditors could not complain that the secured creditor is getting an additional $600,000 on its secured claim placed in a separate class. Franklin could have argued that the healthcare claims were not in fact distinct claims from the pension claims. Rather, it argued that some of the return that the retirees purportedly received on account of their pension claim was actually received on account of their healthcare claims.[242] This is the unequal treatment argument outlined in Section III.C.[243]

Applying the unequal treatment argument to Stockton's circumstances, the current and former workers are receiving more than a fraction of a percent on their healthcare claims. It is just that as a formal matter, some of the

235. *See id.* at 57 (noting that "the City's 'offer' of a *de minimis* ¼ cent-on-the-dollar recovery belies its insinuation that Franklin somehow made unreasonable demands in settlement negotiations over the Plan").

236. *See* 11 U.S.C. § 1126(g) (2012).

237. *See* Franklin Summary Objection, *supra* note 26, at 33 & n.61.

238. *Id.*

239. *Id.*

240. *See id.* at 32.

241. *See id.* at 7, 19, 41.

242. *See id.* at 60–61.

243. *See supra* notes 222–32 and accompanying text.

compensation is paid in the form of a greater recovery on their pensions.[244] Making the argument more powerful, the recovery on the pensions and the healthcare claims were tied together as part of the same settlement agreement.[245] Part of the consideration for the pension recovery came from the current and former workers' agreement to vote their healthcare claims in favor of the plan.[246] Suppose, however, that Stockton did not explicitly require an affirmative vote by its current and former workers and instead relied on the workers' ability to see that an affirmative vote was in their self-interest. Franklin might still be able to prove that some of the pension recovery should be attributable to the healthcare claims by showing that the pension claims are receiving a dramatically higher payment than substantially similar claims. Note that this is not the same as a direct challenge of unfair discrimination, as it requires an overlap between the holders of the claims in the favored class and the holders of the claims in the same class as the objecting creditor. The objecting creditor must be able to argue that the debtor is, in fact, buying the favorable votes. To see this, assume instead that Franklin were placed in a class consisting solely of similar bonds and that the holders of the bonds had no overlap with the holders of the pension claims, and that the holders of the bonds still voted in favor of the class (perhaps because they thought that the workers deserved more as a moral matter). Franklin would not be able to raise an equal treatment argument because it cannot argue that the debtor is effectively buying the votes of the bondholders.

While we find substantial merit in the argument that Stockton's plan did not offer Franklin's unsecured claim treatment equal to that received by the workers' health claims, Judge Klein did not. He stated that the plan complied with § 1123(a)(4)'s requirement of equal treatment without directly addressing Franklin's argument.[247] This is somewhat surprising given that he clearly understood that creditors are willing to sacrifice a return on one claim in order to bargain for a hire return on another. In fact, he relied on this very argument to justify the preferential treatment afforded to worker pensions, arguing that the workers were indeed sacrificing as well by accepting a reduction in their wages and other benefits.[248]

Franklin had a second argument as to why the workers were receiving more for their healthcare claims. It argued that the plan overvalued the size of the healthcare claims by failing to use the present value of future costs.[249]

244. *Id.* at 41.

245. *Id.* at 41–42.

246. *Id.* at 33.

247. *See* Stockton Transcript, *supra* note 6, at 33.

248. *Id.* at 21, 26, 28, 34–35.

249. *See* Franklin Summary Objection, *supra* note 26, at 60.

Failing to discount future claims would be an obvious violation of bankruptcy norms,[250] raising the question of why the city would do this. Overstating the size of the claims would not have a material effect on the amount paid to the workers and retirees. Franklin alleges that the failure to discount future amounts roughly doubled the size of the healthcare claims.[251] However, the recovery rate on these claims in this class was essentially zero (0.25%),[252] and doubling nothing still gives you nothing.[253] The explanation for Stockton's failure to discount probably lies in the voting mechanics. Stockton probably feared that some current and former workers would vote against the plan because they believed they were entitled to have both their pension and healthcare claims paid in full. In this event, with Franklin's opposition, Stockton would have to convince a sizeable number of current and former workers to return their ballots, and this may have been hard to do. Otherwise, under the applicable voting rule, the amount of the claims within the class voting to accept the plan would be insufficient for the class to have accepted the plan.[254] By inflating the size of the workers' claims, Stockton eased its task of soliciting sufficient votes to ensure the class's acceptance of the plan.

Franklin spent a great deal of time objecting to the placement of its claim in the same class as the healthcare claims and in a class separate from the pension obligations and several other bond series that received substantially greater recoveries than Franklin.[255] The reason is unsurprising in light of the discussion in Section III.A above.[256] If Franklin could convince the court that all of the claims belonged in the same class, then the better treatment received by the holders of the pensions and the other bonds would violate the requirement that all claims in a class receive the same treatment. If Franklin could convince the court that their claims belonged in a separate class from the healthcare claims, it could vote to reject the plan and invoke the unfair discrimination standard.

250. *See* 11 U.S.C. § 502(b)(2) (2012); Pension Benefit Guar. Corp. v. Belfance (*In re* CSC Indus., Inc.), 232 F.3d 505, 507–08 (6th Cir. 2000) (stating that the allowed amount of unmatured future liabilities must be discounted to present value); Pension Benefit Guar. Corp. v. CF&I Fabricators (*In re* CF&I Fabricators of Utah, Inc.), 150 F.3d 1293, 1300 (10th Cir. 1998) (same).

251. *See* Franklin Summary Objection, *supra* note 26, at 61.

252. *Id.* at 7.

253. We may be understating the importance of the effect of this misstatement on the pro rata share that Franklin would receive. After Judge Klein affirmed the city's valuation of the claims, Franklin objected on the grounds that this would reduce its recovery. *See* Stockton Transcript, *supra* note 6, at 44.

254. *See* 11 U.S.C. § 1126(c); § 901(a) (incorporating § 1126(c) into Chapter 9).

255. *See* Franklin Summary Objection, *supra* note 26, at 30–41.

256. *See supra* notes 203–18 and accompanying text.

Finally, Franklin contended that the classification of its claim was improper because the claim's treatment under Stockton's plan unfairly discriminated against it.[257] The contention assumes that the unfair discrimination standard informs the test for the proper classification of claims. Stockton clearly engineered its classes to obtain a desirable voting outcome within each class. A court applying the no-gerrymandering test, therefore, must ask whether the debtor has a valid "independent" reason to separately classify claims.[258] Stockton could respond that it has an independent reason: it wishes to pay its retirement obligations in full to preserve the goodwill of its current and future workers. This, of course, is the central argument in the unfair discrimination analysis. In this case, whether the classification is permissible turns on whether the plan's favorable treatment of Stockton's workers is fair to Franklin. Franklin's argument was anticipated by the leading bankruptcy treatise:

> [T]he separate classification, when coupled with materially different economic treatment of the classes, can have the effect of unfair discrimination among similarly situated creditors. Classes may, by voting for the plan, accept the different treatment, but courts should be cautious about carrying this reasoning too far. Although the "unfair discrimination" standard technically applies only under section 1129(b) when a class has not accepted the plan, a court should consider a confirmation objection based on alleged improper classification raised by a dissenting creditor in an accepting class if the combination of separate classification and materially different treatment results in substantially different economic effects between the two classes and the purpose and effect is other than the debtor's good faith effort to protect its future business operations.[259]

The objection to claim classification based on unfair discrimination should not be allowed. Allowing the results of an inquiry into unfair discrimination to determine whether classification is proper not only confuses the question of whether the classification of a claim has a legitimate basis with the question of whether the treatment of the claim under the plan is unfair. Whether the plan has constructed classes to engineer acceptance of the plan is one thing; whether the plan's treatment of a rejecting class is fair is another. More importantly, it enables the opponent of the classification to evade § 1129(b)(1)'s class-based standard for unfair discrimination. Although § 1129(b)(1) prohibits a rejecting member of an accepting class from

257. *See* Franklin Summary Objection, *supra* note 26, at 46–51.

258. *See supra* notes 215–18 and accompanying text.

259. 7 COLLIER ON BANKRUPTCY, *supra* note 50, ¶ 1122.03[3][a], at 1122-13 (citing *In re* Jersey City Med. Ctr., 817 F.2d 1055 (3d Cir. 1987)).

contesting its treatment under the plan as unfair, the objector can raise the same objection as a ground for contesting the classification of its claim.[260] This effectively renders § 1129(b)(1)'s class-based unfair discrimination standard inapplicable. The issue is not merely a "technical" one of fitting the standard to the right Code provision, as the quotation above suggests. It is whether courts should allow a creditor to avoid Congress's carefully considered restriction on standing to object to a treatment under the plan as fair.[261] The class-based restriction eliminates the holdup power of the objecting class member, because the objector cannot hold the plan hostage to its objection based on unfair discrimination. Allowing the same objection as a challenge to classification effectively reinstates this holdup power, thereby increasing the bankruptcy costs of reorganization.

CONCLUSION

The Bankruptcy Code incorporates a standard of unfair discrimination that it leaves unclear. Nonetheless, bankruptcy's fair discrimination standard has a determinable content that remains unchanged in Chapter 9. The standard does not allow the plan proponent the complete discretion to favor one class over other coequal classes. Instead, case law requires the plan to treat classes equally unless the favorable treatment of a class falls within a limited number of judicially recognized categories. These categories limit the types of circumstances in which a municipal reorganization plan may deviate from bankruptcy's requirement that coequal classes receive the same proportionate distribution. Although municipal workers and retirees are sympathetic creditors who attract strong political support, none of the circumstances that allow a plan to favor them apply. Case law aside, the normative case for favoring them is not compelling. Considerations of fairness, such as those based on desert or need, do not support treating retirees and active workers better than other creditors in a municipality's bankruptcy.

260. *See* FED. R. BANKR. P. 3013 (providing that the court may, on motion, determine proper classification under § 1122).

261. *See* 11 U.S.C. § 1129(b)(1) (2012).