

## The Stockton Saga Continues: Untouchable Pensions on the Chopping Block?

Article By:

Corporate and Securities Finance Practice

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[Judge Christopher M. Klein's decision](#) to accept the City of Stockton's petition for bankruptcy on April 1, 2013 set the stage for a battle over whether public workers' pensions can be reduced through municipal reorganization.

Stockton's public revenues tumbled dramatically when the recession hit, leaving Stockton unable to meet its day-to-day obligations. Stockton slashed its police and fire departments, eliminated many city services, cut public employee benefits and suspended payments on municipal bonds it had used to finance various projects and close projected budget gaps. Stockton continues to pay its obligations to California Public Employees' Retirement System ("CalPERS") for its public workers' pensions. Pension obligations are particularly high because during the years prior to the recession, city workers could "spike" their pensions—by augmenting their final year of compensation with unlimited accrued vacation and sick leave—in order to receive pension payments that grossly exceeded their annual salaries.

[When Judge Klein accepted Stockton's petition April 1, 2013](#), he reasoned that Stockton could not perform its basic functions "without the ability to have the muscle of the contract impairing power of federal bankruptcy law." Judge Klein noted that his decision to "grant an order for relief ... is merely the opening round in a much more complicated analysis." The question looming is whether the contract-impairing power of federal bankruptcy law is strong enough to adjust state pension obligations.

Stockton will have the opportunity to present a plan of adjustment, which must be approved through the confirmation process. No plan of adjustment can be confirmed over rejection by a particular class of creditors unless the plan (1) does not discriminate unfairly, and (2) is fair and equitable with respect to each class of claims that is impaired under or has not accepted a plan. Judge Klein said that if Stockton "makes inappropriate compromises, the day of reckoning will be the day of plan confirmation."

Stockton's plan of adjustment will likely propose periods of debt service relief and interest-only payments for some municipal bonds, followed by amortization. Stockton intends to actually impair other municipal bonds, potentially paying only cents on the dollar. However, Stockton does not intend to reduce its pension obligations to CalPERS under the plan. Provisions of the California Constitution

and state statutes prohibit the reduction of public workers' pensions, even in bankruptcy proceedings. These California state law provisions were thought to make public pensions virtually untouchable. Yet, the plan may not be confirmable if it impairs Stockton's obligations to bondholders but not its obligations to CalPERS. Bondholders and insurers will surely vote against and object to the plan, claiming it unfairly discriminates against them, and Judge Klein will have to decide whether the treatment constitutes unfair discrimination. The unfair discrimination claim may have merit, because an overarching goal of federal bankruptcy law is to equitably allocate losses among competing creditors. Federal bankruptcy law often trumps state laws, but there is no precedent for how federal bankruptcy law applies to California's pension provisions.

For now, cash-strapped municipalities around the country—and their creditors—are watching to see just how Stockton will restructure its obligations.

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