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Uncertainty Surrounding Takings Claimants' Rights in Municipal Bankruptcies

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Introduction

Governments in the United States and its territories have the power to exercise eminent domain so long as they provide property owners with the constitutionally guaranteed “just compensation.” The Fifth Amendment’s Takings Clause specifically prescribes this remedy for parties whose property has been subject to a government taking.¹ “Just compensation” has proven to be an issue in the context of bankruptcy, as bankruptcy law inherently allows debtors to alter their obligations to their creditors.²

In response to Puerto Rico’s financial crisis, Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”), which created a modified version of municipal bankruptcy code.³ Under PROMESA, the Financial Oversight and Management Board of Puerto Rico (“the Board”) filed a plan of adjustment with respect to Puerto Rico’s debts. A group of creditors (the “Takings Claimants”) objected to the plan, arguing it was unconfirmable because the Board was unable to demonstrate that “the debtor [wa]s not prohibited by law from

¹ U.S. Const. amend. V cl. 5 (“Nor shall private property be taken for public use, without just compensation”).

² See generally 1 Norton Bankr. L. & Prac. 3d § 3:1 (July 2023 Update).

³ *In re* Financial Oversight and Management Board for Puerto Rico v. Cooperative de Ahorro y Credito Abraham Rosa, No. 22-1119 slip op. at 8–9 (1st Cir. July 18, 2022).

taking any action necessary to carry out the plan.”⁴ Specifically, the Takings Claimants argued the plan violated the Fifth Amendment’s Takings Clause.⁵

This article addresses whether a plan of adjustment can satisfy section 2174(b)(3) of PROMESA if it gives takings claimants less than “just compensation” for their prepetition takings claims. Part I describes how claims arising from takings statutes are classified in bankruptcy. Part II discusses the relationship between the Fifth Amendment and bankruptcy law and compares the two diverging views on this issue resulting from the First and Ninth Circuits’ split.

I. Bifurcation of Takings Claims in Bankruptcy

A “quick take” statute permits the government to “acquire private property through eminent domain by depositing an estimated compensation amount” with the court.⁶ The issue in bankruptcy proceedings is whether a debtor can bifurcate “quick take” takings claims into (a) a secured claim up to the deposited amount and (b) an unsecured claim for the excess amount.⁷ The Board’s plan of adjustment bifurcated takings claims arising from quick take actions, and treated takings claims arising from inverse condemnation actions as unsecured.⁸ Overall, bifurcation would create a general, unsecured claim for any taking claimant who did not receive a deposit securing the full amount of their property’s value.

A plan of adjustment can only be confirmed if it does not violate the law.⁹ There are two views regarding whether the bifurcation of takings claims violates the law in this context. One view is that bifurcation violates the Fifth Amendment because classifying takings claims as

⁴ *Id.*

⁵ *Id.*

⁶ *Id.* at 11.

⁷ *Id.* at 11–12.

⁸ *Id.*

⁹ *See* 48 U.S.C. § 2174(b)(3).

“unsecured” subjects the claim to discharge or impairment.¹⁰ Discharge or impairment of a claim would breach the Takings Clause’s required remedy of “just compensation.” In support of this view, the lower court in *In re Financial Oversight and Management Board* held that “holders of takings claims have a constitutional right to just compensation that is not subject to impairment or discharge under a plan of adjustment.”¹¹ Under this approach, bifurcation of takings claims violates the Constitution and a plan of adjustment treating these claims as unsecured cannot be confirmed.

The second view opines that bifurcation of takings claims is appropriate in a plan of adjustment provided that the claimants had an opportunity to object to the deposited amount of compensation. This interpretation is based on the concept of notice; because the claimants were given the opportunity to object to their compensation, their Takings Clause violations are waived if they acquiesce. The Ninth Circuit adopted this reasoning in *In re City of Stockton*, where it found that property taken under a California “quick take” statute was not secured in excess of the deposit when the city filed bankruptcy.¹² The court held that because the takings claimants failed to object to the government’s deposited amount (which was intended to “estimate compensation”), the claimants waived their right to assert a future Takings Clause violation.¹³ This approach places conditions on the takings claimant’s ability to receive the constitutional remedy of “just compensation.”

II. Bankruptcy Law’s Relationship to the Fifth Amendment in a Plan of Adjustment

¹⁰ See James L. Buchwalter, Annotation, *Application of Chapter 9 Bankruptcy Relief for Municipalities*, 28 A.L.R. Fed. 3d Art. 5 (2018).

¹¹ *In re Financial Oversight and Management Board*, 637 B.R. 223, 295 (D.P.R. 2022).

¹² *In re City of Stockton, California*, 909 F.3d 1256 (9th Cir. 2018).

¹³ *Id.* at 1267 (“Thus, when the bankruptcy was filed, Cobb did not possess a right to the property protected by the Fifth Amendment... What remained was bare legal title—without any other property rights and subject to defeasance by the prior litigation—and an unsecured statutory monetary claim for greater compensation.”).

In connection with a takings claim in bankruptcy, there are two competing constitutional interests: (1) the remedy prescribed by the Fifth Amendment’s Takings Clause and (2) the power to create bankruptcy law found in Article I, Section 8.¹⁴ The Takings Clause is violated when a government takes one’s property without just compensation.¹⁵ However, title 11 of the United States Code (the “Bankruptcy Code”) allows debtors to alter their obligations to creditors, including those with takings claims. The argument that bankruptcy law supersedes the Fifth Amendment is policy-based, while the alternative argument is textual.

The First and Ninth Circuits have issued split opinions on the constitutional issue of takings in municipal bankruptcies.¹⁶ In both cases, claimants objected to the debtor’s plan of adjustment for an alleged violation of the “just compensation” requirement provided by the Fifth Amendment, but the courts came to opposite conclusions.

Procedurally, these cases are slightly different. In *Stockton*, the City of Stockton filed bankruptcy under Chapter 9 of the Bankruptcy Code, which at the time was the largest United States municipality to file bankruptcy.¹⁷ In *In re Financial Oversight and Management Board*, Puerto Rico filed bankruptcy under Title III of PROMESA, which created a procedure similar to Chapter 11 of the Bankruptcy Code.¹⁸ The lower court in *In re Stockton* found no merit in the takings claimants’ objections and confirmed the city’s plan of adjustment and the Ninth Circuit affirmed.¹⁹ Conversely, the lower court in *In re Financial Oversight and Management Board*

¹⁴ See U.S. Const. amend. V; U.S. Const. art. I, § 8, cl. 4.

¹⁵ See *Knick v. Township of Scott*, 139 S. Ct. 2162 (2019).

¹⁶ See *In re City of Stockton*, 909 F.3d at 1256; *In re Financial Oversight and Management Board for Puerto Rico v. Cooperative de Ahorro y Credito Abraham Rosa*, No. 22-1119 slip op. (1st Cir. July 18, 2022).

¹⁷ *In re City of Stockton*, 909 F.3d at 1259.

¹⁸ *In re Financial Oversight and Management Board*, No. 22-1119 slip op. at 10.

¹⁹ *In re City of Stockton*, 909 F.3d at 1259.

found that the plan of adjustment could not be confirmed without giving just compensation to the takings claimants, and the First Circuit affirmed.²⁰

Despite procedural differences, the issues in these cases are nearly identical. Both the City of Stockton and Puerto Rico utilized “quick take” statutes to take property by eminent domain prior to their bankruptcies. These statutes both required a deposit with the court that would serve as “estimated compensation” for the property owners. The claimants all objected to the municipalities’ plans of adjustment for violation of the remedy requirement of the Takings Clause. The courts’ opinions diverge on whether municipal bankruptcy law, a unique process for debt relief, can alter long-standing constitutional requirements.

A. Bankruptcy Law can Alter the Fifth Amendment’s Requirements

The first argument states that bankruptcy law supersedes the Fifth Amendment and therefore can alter the Takings Clause’s remedy requirement. This argument is rooted in policy, positing that bankruptcy reorganization plans should allow a debtor to recover financially while maximizing its creditors’ payout.²¹ A plan of adjustment that would guarantee “just compensation” to all takings claimants would probably not strike a balance between creditor payoffs (takings claimants paid in full) and debtor financial recovery (Puerto Rico unable to pay the plan’s restructured debts). Further, the Supreme Court held that a property owner subject to a quick-take action may not have a claim for violation of the Fifth Amendment because they received some form of compensation.²² The Ninth Circuit adopted this view. The court held that a plan of adjustment could be confirmed without providing “just compensation” because the property owners had an opportunity to object to the compensation amount prior to the

²⁰ *In re Financial Oversight and Management Board*, No. 22-1119 slip op. at 8–9, *aff’d*, *In re Financial Oversight and Management Board*, No. 22-1119 slip op. (1st Cir. July 18, 2022).

²¹ See *In re City of Stockton*, 909 F.3d at 1263.

²² See *Knick v. Township of Scott*, 139 S. Ct. 2162 (2019).

bankruptcy, therefore their Fifth Amendment claims had been waived.²³ The *Stockton* court found that “‘just compensation’ under the Takings Clause is not equivalent to ‘full compensation.’”²⁴ This argument asserts that sound policy reasons—like notice and opportunity to be heard for the creditor, and feasibility of the plan for the debtor—can justify the waiver of the “just compensation” requirement.

B. The Fifth Amendment Supersedes Bankruptcy Law

The alternate view is that the Fifth Amendment supersedes bankruptcy law. This view is grounded in the explicit language of the Fifth Amendment, which prescribes damages of “just compensation.” This specifically enumerated remedy supersedes bankruptcy law because bankruptcy laws were created using derivative constitutional power, not explicit power (“[The Congress shall have Power . . .] To establish a uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States . . .” Article I § 8 cl. 4).²⁵ The Supreme Court addressed the relationship between these two clauses in *Louisville Joint Stock Land Bank v. Radford*, holding that the Fifth Amendment “constrains the power conferred by the Bankruptcy Clause in Article I.”²⁶ The Court also stated that “[t]he bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment.”²⁷ In 2022, the First Circuit rejected the Ninth Circuit’s reasoning on this issue and held that a plan of adjustment violated the Fifth Amendment if it did not provide “just compensation” to prepetition takings claimants. That court opined that “reduced to its nub, the issue we decide is rather simple. The Fifth Amendment provides that if the government takes private property, it must pay

²³ *In re City of Stockton*, 909 F.3d at 1267.

²⁴ *Id.* at 1268.

²⁵ *In re Financial Oversight and Management Board*, No. 22-1119 slip op. at 20; see *In re City of Stockton*, 909 F.3d at 1273–74 (Friedland, J. dissenting).

²⁶ *In re City of Stockton*, 909 F.3d at 1272 (citing *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935)).

²⁷ *Id.*

just compensation.”²⁸ Ultimately, this argument is based on the premise that the Bill of Rights (which includes the Takings Clause) cannot be infringed upon by the government.²⁹

Conclusion

Courts are split over whether plans of adjustment in municipal bankruptcies can affect the constitutional rights of takings claimants. The Supreme Court recently declined to review *In re Financial Oversight and Management Board*, therefore the law remains unclear regarding the true relationship between the Fifth Amendment and bankruptcy law. The First Circuit has held that the right to “just compensation” cannot be altered by a bankruptcy plan, whereas the Ninth Circuit held that the rights of takings claimants in bankruptcy reorganization can be altered for sound policy reasons.

²⁸ *In re Financial Oversight and Management Board*, No. 22-1119 slip op. at 30–31.

²⁹ *In re City of Stockton*, 909 F.3d at 1271.