Judge Approves California City's Bankruptcy-Exit Plan.

The federal judge overseeing the two-year-long bankruptcy of Stockton, Calif., ruled Thursday that the distressed city can exit court protection without deeper cuts to its pension obligations.

U.S. Bankruptcy Judge Christopher Klein called the city's reorganization plan, which raises taxes and slashes payments to bondholders, "the best that can be done" during a hearing in Sacramento.

The decision is a victory for public-pension advocates who worried the judge would reject the plan because the city didn't cut obligations to California Public Employees' Retirement System, which controls city workers' retirement money. The same judge about a month ago said the city had the power to sever its ties with the retirement system, known as Calpers. The judge overseeing Detroit's bankruptcy case has also ruled that payments into pension funds can be reduced while a city is insolvent.

The resolution of the Stockton case is "unlikely" to lead other U.S. cities to view bankruptcy "as an attractive option for resolving serious financial challenges," said Standard & Poor's Ratings Services in a statement.

Calpers, the largest public pension in the U.S., said in a statement, "The judge recognized that the city's employees and retirees have already made significant concessions" and "that further impairing pensions would harm them even more."

Judge Klein approved the city's reorganization plan over protests from two Franklin Templeton Investments-managed funds, which underwrote the bonds for Stockton's fire stations and parks. The funds argued that the city could afford to repay more than its $4 million offer.

Critics of the exit plan have said the city will continue to struggle to afford the state-mandated payments to Calpers.

"We are disappointed," Franklin Templeton lawyer James Johnston said after the ruling.

Meanwhile, many pension fund lawyers applauded the judge's decision. Harvey Leiderman, a partner at Reed Smith LLP who represents public-employee pension funds, said the confirmation of Stockton's plan "threw cold water on anyone who thinks there is an easy exit off ramp for resolving your fiscal issues" through a municipal bankruptcy. Calpers is a client of Mr. Leiderman's, but he didn't represent the system in the Stockton case.

"The outcome in Stockton is more evidence that bankruptcy is not an appropriate tool to jettison pension debt," said Teague Paterson, a lawyer at Beeson, Tayer & Bodine, who also represents pension funds and who filed a brief in the Stockton case.

City leaders put Stockton, a city of 300,000 people located about 80 miles inland from San Francisco, into bankruptcy in June 2012, after it was hit hard by the housing crash. Judge Klein also blamed the city's financial woes on former leaders who offered overly generous pay to city workers and took on debt for new projects that the city couldn't afford.

It was the second-largest financial failure by a U.S. city and one of several California cities—San Bernardino, Vallejo and Mammoth Lakes— to seek bankruptcy protection in recent years. It needed a judge to approve its plan to repay creditors before it could exit from bankruptcy.

Instead of cutting payments to Calpers, the city chose to raise taxes. Last year, voters approved a 3/4-cent sales tax to pay for more police officers. More than 1,000 workers and retirees who had $538 million in claims against the city also agreed to accept one-time payments worth $5.1 million instead.

The judge on Thursday highlighted how much the city spent during its two years in bankruptcy, saying that legal fees amounted to $13.8 million. “It’s impossible” to go through a municipal bankruptcy, he said, “without spending an eight-digit number.”

THE WALL STREET JOURNAL

By KATY STECH and DAN FITZPATRICK

Updated Oct. 30, 2014 5:00 p.m. ET

Write to Katy Stech at katherine.stech@wsj.com and Dan Fitzpatrick at dan.fitzpatrick@wsj.com