

# Clients & Friends Memo

## Court Holds that Stockton is Eligible to File for Chapter 9

April 3, 2013

On April 1, 2013, the U.S. Bankruptcy Court for the Eastern District of California ruled that the City of Stockton qualified to file for protection under chapter 9 of the Bankruptcy Code. The court's decision on this issue serves as an important milestone for chapter 9 jurisprudence, clarifying the requirements for "good faith" negotiations and being "insolvent" as conditions to filing for chapter 9 protection. Significantly, the court held that a municipal debtor need not negotiate with all of its creditors, only those that it intends to impair.

### Statutory Background

The Bankruptcy Code enumerates various criteria with respect to a municipality's eligibility to file for chapter 9 protection. In pertinent part, section 109(c) of the Bankruptcy Code provides that an entity may be a debtor under chapter 9 only if such entity is (i) insolvent, (ii) is authorized to file for chapter 9 under applicable state law, and (iii) has "negotiated with its creditors in *good faith* and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under" its plan of adjustment. 11 U.S.C. § 109(c)(2)-(5) (emphasis added). Courts have previously interpreted the good faith negotiations requirement as mandating prepetition negotiations among the municipality and creditors that the municipality intends to impair under its plan of adjustment. See *In re City of Vallejo*, 408 B.R. 280 (9th Cir. BAP 2009). In addition, section 901 of the Bankruptcy Code, which incorporates other provisions of Title 11, requires that a debtor file its petition in good faith.

Further, section 921(c) provides that the bankruptcy court "*may* dismiss the petition if the debtor did not file in good faith or if the petition does not meet the requirements of this title." 11 U.S.C. § 921(c)(emphasis added).

### Facts

On June 28, 2012, the City of Stockton, a city with over 290,000 residents, filed for chapter 9 protection. Stockton was one of three California cities to file for chapter 9 in the summer of 2012—the others being San Bernardino and Mammoth Lakes. However, Stockton's filing represents the largest city to ever seek protection under chapter 9 of the Bankruptcy Code. Stockton's chapter 9

filing was precipitated by reliance on “bubble” economic assumptions to support significant debt obligations, spending to revitalize the city’s downtown, and rising pension costs. The City was particularly hard hit by the subprime mortgage crisis and had one of the highest foreclosure rates in the nation (which, in turn, decreased tax revenues). In 2012, Stockton defaulted on its bond obligations, which resulted in the receivership of several properties owned by Stockton, including City-owned parking garages and a building intended to be the Stockton City Hall. In addition, Stockton’s general fund had a \$26 million deficit, which further inhibited the City’s ability to service its debt obligations and continue to pay for basic municipal services.

Stockton had signaled for months that it was financially distressed and that a chapter 9 filing could be imminent. Indeed, in March 2012, Stockton commenced a neutral evaluation and mediation with certain of its creditors, as required under California’s Assembly Bill 506 (“AB 506”), a state statute that sets conditions for a municipality’s eligibility to file for chapter 9. Under AB 506, a municipality may file for chapter 9 if it engages in a neutral mediation with its creditors for at least 60 days. After 90 days of mediation, the City of Stockton and its creditors failed to come to an agreement. Having made an attempt to reach an agreement with its creditors outside of court, Stockton was thereafter permitted under AB 506 to file for bankruptcy protection under chapter 9.

During its neutral evaluation process under AB 506, Stockton devised an “Ask” plan,<sup>1</sup> which provided for the adjustment of the City’s debts and liabilities. Under the Ask plan, Stockton proposed significant impairments to the claims of bondholders (including bonds issued to finance prior pension deficits), while continuing to make post-petition payments to its largest creditor, the California Public Employees Retirement System (“CalPERS”). Bondholders expressed concern during the neutral evaluation process that their claims would be significantly impaired, notwithstanding the fact that certain series of bonds were issued to cover the City’s otherwise unfunded pension obligations to CalPERS. CalPERS’ claims, meanwhile, would increase by approximately 94% over the next 10 years, and such increase was partially attributable to an allegedly fraudulent practice known as “pension spiking.”<sup>2</sup> The Ask plan also proposed to unilaterally modify retirees’ health benefits and pertinent terms of employees’ collective bargaining agreements. The fact that Stockton was proposing that CalPERS be left untouched, while debt service payments for its bond obligations (including its pension obligation bonds) would be discontinued during the pendency of the chapter 9 case, was met with strong opposition by certain of Stockton’s key creditor constituencies.

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<sup>1</sup> An “Ask” plan, also known as a pendency plan, is an interim budget that a municipal debtor may employ during the pendency of its case. Stockton adopted its Ask plan shortly before commencing its chapter 9 case.

<sup>2</sup> “Pension spiking” refers to a practice whereby retirees would receive pension payments that grossly exceeded their annual salaries.

### **The Eligibility Dispute**

In early August 2012, several creditors, including National Public Finance Guarantee Corporation, Assured Guaranty, Franklin Advisers, and Wells Fargo (collectively, the “Capital Markets Creditors”), decided to challenge Stockton’s eligibility to seek chapter 9 protection. These creditors asserted that Stockton did not qualify to be a chapter 9 debtor, because (i) the City did not undertake good faith negotiations with its creditors prepetition, as required under AB 506 and section 109(c)(5)(B) of the Bankruptcy Code, and (ii) the City failed to demonstrate that it was insolvent. Beginning on March 25, 2013, the parties set forth their arguments regarding Stockton’s eligibility to be a chapter 9 debtor at a three-day evidentiary trial before Judge Klein.

At trial, the Capital Markets Creditors argued that the City did not engage in good faith negotiations because (i) the City refused to seek meaningful concessions from CalPERS, its largest unsecured creditor, (ii) the City employed a “take it or leave it” approach in its negotiations with the Capital Markets Creditors by proposing to wipe out their claims in bankruptcy, and (iii) the City submitted a plan that benefits CalPERS at the expense of similarly situated creditors. Further, the Capital Markets Creditors argued that the City admitted it had never negotiated with CalPERS, that it never considered any pension reductions when developing its pendency plan, and that it failed to make a reasonable inquiry into its decision not to impair CalPERS. According to the Capital Markets Creditors, the decision process not to impair CalPERS was tainted by the self-interest of City politicians seeking to protect their own pensions. The Capital Markets Creditors maintained that the City only met with them twice, never took any interest in engaging in any meaningful negotiations, and that the City’s decision not to impair CalPERS would force other creditors to fight over a reduced pool of assets. Finally, the Capital Markets Creditors argued at trial that pursuant to section 109(c), only the City (and not the Capital Markets Creditors) had the obligation to engage in good faith negotiations.

As to the City’s solvency, the Capital Markets Creditors asserted that Stockton failed to produce reliable cash flow projections evidencing that it was unable to pay debts as they became due. To the contrary, the Capital Markets Creditors argued that Stockton budgeted itself into bankruptcy. Indeed, the Capital Markets Creditors argued at trial that Stockton was able to achieve various budget efficiencies that would allow it to raise revenues and achieve positive cash flow outside of bankruptcy.

In contrast, the City argued that it had engaged in good faith negotiations with all of its creditors, and that it was the Capital Markets Creditors who had not negotiated in good faith. According to the City, the Capital Markets Creditors walked away from the negotiations once they learned that CalPERS would not be impaired. They also did not pay expenses for the AB 506 neutral evaluation process. Furthermore, the City argued that it chose not to impair CalPERS because such impairment would expose the City to approximately \$1 billion under applicable state law. Finally,

the City asserted that it was cash insolvent as of the petition date and that any inquiry into the City's budgetary decisions would be impermissible under section 904 of the Bankruptcy Code.

### **The Court's Decision**

In ruling from the bench, Bankruptcy Judge Christopher M. Klein concluded that Stockton satisfied all of the requirements of section 109(c). Pursuant to AB 506, Stockton chose to engage in a neutral evaluation process with its creditors. When examining applicable California law, Judge Klein concluded that both creditors and municipalities have a duty to engage in good faith negotiations. Here, the Court concluded that it was the Capital Markets Creditors that had not negotiated in good faith and "voted with their feet" once they learned that CalPERS would not be impaired. In fact, the Court was even concerned that none of the Capital Markets Creditors paid their appropriate share of the neutral evaluation costs, as required under applicable California law. Thus, the Court concluded that the City was authorized to file for chapter 9 under AB 506, and that the Capital Markets Creditors waived their right to complain about the AB 506 process because they attempted to stall the neutral evaluation process.

The Court also concluded that the City was clearly insolvent, a requirement for filing for chapter 9. Despite efforts to cut its workforce and pension obligations, the Court noted that the City would be unable to continue to offer acceptable municipal services to its citizens and that the City would be unable to pay its debts as they came due. Indeed, had Stockton not suspended payments on its lease revenue bonds and other bonds tied to the City's general fund, the City would have been "in the red" on the petition date. There was also significant evidence that the City would have been unable to make basic payroll expenses for July 2012. Further slashing the City employees' benefits, according to the Court, would have been devastating to the health, safety, and welfare of Stockton's citizens. Stockton's police force is already at dangerously low levels and, meanwhile, crime rates in the City are rising dramatically. The Court determined that this was not a case where the City had budgeted itself into bankruptcy. To the contrary, the Court determined that the City was indeed insolvent and that its insolvency was tied to exogenous factors that were beyond the City's control.

As to the requirement that a chapter 9 debtor negotiate with its creditors, the Court determined that the City had satisfied its obligation. Section 109(c)(5) of the Bankruptcy Code provides for separate alternatives where a court may determine that a municipal debtor has negotiated in good faith. Under section 109(c)(5), those scenarios include: (i) where the municipality has obtained the agreement of a majority in each class that it intends to impair; (ii) the municipality has negotiated in good faith with creditors and has failed to obtain the consent of those holding a majority of each class that it intends to impair; and (iii) where such negotiation is otherwise impracticable.

The Court ruled that good faith negotiation is a reciprocal obligation. As stated by Judge Klein, one “cannot negotiate with a stone wall.” Ultimately, the Court suggested that it was the Capital Markets Creditors who did not negotiate in good faith. Furthermore, evaluating the overall negotiation process, the Court found that the City negotiated with its creditors in good faith (as evidenced by its negotiation with employees and reduction of their health benefits), and that it had the right to impair its creditors (which, as the Court noted, is precisely what chapter 9 is about).

In another attempt to establish that the City was not eligible for chapter 9 protection, the Capital Markets Creditors also argued that the City filed for chapter 9 solely to wipe out their claims. Those allegations were based on a statement that a city official had made on February 28, 2012, stating that City employees had suffered enough and that it was time for the bondholders to suffer. The Court found this argument unpersuasive. The Court noted the City had engaged in ongoing negotiations with all of its creditors, and that it secured significant reductions of its employees’ benefits during the neutral evaluation process. These reductions, according to the Court, contradicted the Capital Markets Creditors’ arguments that the City specifically targeted them.

Finally, the Court held that the City had no obligation to negotiate with CalPERS because it did not intend to impair them. Even though CalPERS is a creditor, under section 109(c)(5)(B), a municipal debtor need only engage in good faith negotiations with the creditors that it *intends to impair*. Here, CalPERS was not impaired.

The Court then turned to the issue of whether Stockton filed its petition in good faith, as required under section 901 of the Bankruptcy Code (which is separate from its obligation to negotiate in good faith with its creditors). After examining Stockton’s history, what precipitated its filing, and its future, the Court concluded that Stockton had in fact filed its petition in good faith. Among other things, the Court noted that it was apparent that the City would not be able to provide basic municipal services to its citizens without the “muscle of the contract impairing power of bankruptcy.”

Accordingly, the Court concluded that Stockton qualified to be a chapter 9 debtor under sections 901 and 109(c) of the Bankruptcy Code. Notably, however, the Court did acknowledge that the Capital Markets Creditors may have legitimate concerns regarding the treatment of CalPERS. The ultimate day of reckoning will be during the plan confirmation process. If the plan of adjustment discriminates unfairly and does not treat creditors in a fair and equitable manner, then the plan of adjustment would likely not be confirmable. However, the treatment of creditors, according to the Court, is not a question that is appropriate at this stage of the case.

Judge Klein indicated that a written opinion on this matter will be forthcoming.

**Conclusion**

The chapter 9 qualification hearing is an important milestone and provides creditors an opportunity to both force meaningful prepetition negotiations and to challenge an ill-conceived petition. But negotiations require good faith efforts from both sides. The ultimate battleground over the treatment of creditors under a chapter 9 plan is the confirmation of the debtor’s plan. The standards for such confirmation will undoubtedly be tested and clarified in future proceedings.

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