

## California Dreaming? CalPERS And San Bernardino's Ch. 9

*Law360, New York (December 21, 2012, 11:43 AM ET)* -- California has seen a string of three Chapter 9 filings this year and faces a long line of distressed municipalities. Given this backdrop, the California Public Employees' Retirement System (CalPERS) figures to play a prominent role in the resolution of many of these situations (in or out of bankruptcy). Thus, the bond-buying public will scrutinize closely any steps that CalPERS takes to protect its claims in the Bankruptcy Court.

In late November, CalPERS filed a motion in the San Bernardino Chapter 9 bankruptcy, seeking to lift the automatic stay to pursue payment in full of outstanding pension obligations of the city's employees or, alternatively, for the appointment of a receiver to ensure those payments. In re City of San Bernardino, Calif., (Bankr. C.D. Cal. Nov. 27, 2012) Case No. 12-blk-28006-MJ) (Docket No. 228). The motion will likely ripple through the California municipal bond world and have ramifications in numerous cases.

San Bernardino, a city with over 210,000 residents, commenced its Chapter 9 case on Aug. 1, 2012. Like other municipalities in California, the city's filing and financial distress were precipitated by falling revenues, an unsustainable capital structure and mounting pension costs. Unlike Mammoth Lakes and Stockton (which also filed for Chapter 9 in 2012), San Bernardino did not negotiate with its creditors prior to filing for Chapter 9, as required under AB 506, a state statute that sets parameters for a municipality's eligibility to file under Chapter 9. Instead, the city was the first to use another provision of AB 506 that permits municipalities to file for Chapter 9 by declaring a fiscal emergency. San Bernardino has also missed \$6.9 million in pension payments to CalPERS after filing for bankruptcy.

In October 2012, CalPERS and a city employees' union filed a preliminary objection to San Bernardino's eligibility to file as debtor under Chapter 9 of the Bankruptcy Code, arguing, among other things, that the city did not satisfy the statutory predicates of AB 506 and that its pendency plan is unfeasible because the city is unable to pay its expenses. That dispute is currently pending, as is a similar dispute in the Stockton bankruptcy. CalPERS subsequently filed its motion to lift the automatic stay.



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CalPERS, in its motion, has taken aggressive positions, arguing that, inter alia, (i) the automatic stay does not apply to CalPERS, because CalPERS is a state actor acting consistent with the state's "police power" and is otherwise protected by section 903 of the Bankruptcy Code; and (ii) to the extent the automatic stay applies, cause exists to lift the stay because the city has violated state law and must pay the pension obligations it owes to CalPERS (as administrative claims). At first blush, each of these arguments could present a rough path for CalPERS.

### ***Police Power***

Federal bankruptcy law generally trumps state law. One exception arises with respect to the state's so-called "police powers." Typically, the Bankruptcy Code cannot override state statutes designed to permit the enforcement of regulatory and criminal law against a debtor. Section 362(b)(4) of the Bankruptcy Code provides an express exception to the Bankruptcy Code's automatic stay to enforce these powers.

In its lift stay motion, CalPERS argues that its right to be paid for pension benefits constitutes a state police power because, as a statutorily created entity, the organization is an "arm of the state." CalPERS further contends that, as an arm of the state, its ability to litigate and enforce state labor laws falls within the purview of section 362(b)(4). At first blush, while untested in this context, CalPERS' argument stretches the limit of the police power exception. CalPERS is not enforcing any criminal or regulatory law, but rather a contractual payment obligation under pension plans that it administers.

### ***Section 903***

Section 903 of the Bankruptcy Code states:

This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality

CalPERS argues that section 903 of the Bankruptcy Code requires that the city continue to pay all obligations owed to CalPERS. However, the Bankruptcy Court in Stockton's Chapter 9 case recently held that the protections of section 903 of the Bankruptcy Code do not permit states to "condition or to qualify, i.e. to 'cherry pick' the application of the Bankruptcy Code provisions that apply in Chapter 9 cases after such a case has been filed." In re City of Stockton (Bankr. E.D. Cal. Aug. 6, 2012).

The court in San Bernardino may similarly hold that CalPERS is not entitled to treatment different than other creditors due to relevant state law, once the state elected to permit San Bernardino to file for Chapter 9. Moreover, on its face, section 903 is drafted to protect the municipality, not other entities.

### ***Lift the Stay***

As for CalPERS' efforts to lift the automatic stay, there is little (if any) legal support for the notion that a court should lift the automatic stay because a debtor owes administrative obligations to creditors. Administrative claimants are entitled to payment in cash, in full, as part of a plan. At this point San Bernardino has not reached the plan stage, and thus, CalPERS' argument appears meritless.

## **Federal/State Law Conflict**

This leaves only CalPERS' argument that the court should lift the stay because the city's failure to pay its obligations to CalPERS violates California state law. This is, naturally, a completely untested theory and one that pits the Supremacy Clause of the U.S. Constitution (stating federal law including the Bankruptcy Code trumps state law) against the 10th Amendment to the Constitution (which reserves for states all rights not granted to the federal government). This fundamental federalism question is the type that frequently goes to circuit courts (and beyond) for final resolution and thus is very hard to predict.

The positions taken by CalPERS are extremely aggressive and novel. Most appear easy to dismiss. The remainder turn on complex constitutional questions beyond the territory bankruptcy courts typically occupy. However, the result of this case could have widespread implications in the three pending California bankruptcies as well as the many other distressed California municipalities. A hearing on CalPERS' motion was scheduled for Dec. 21.

## **Update**

On Dec. 10, 2012, a group of municipal bondholders and Wells Fargo (the indenture trustee) filed an objection to CalPERS' motion to lift the stay. By and large, the bondholders flagged the same issues discussed above, including: (1) CalPERS' task of pension administration is neither a sovereign activity nor an exercise of police or regulatory powers; (2) even assuming CalPERS is an arm of the state, section 903 does not exempt unsecured state creditors from the automatic stay; and (3) noncompliance with state law and failure to pay post-petition administrative expenses do not constitute "cause" to lift the automatic stay. *In re City of San Bernardino, Calif.*, Case No. 12 blk 28006 MJ (Bankr. C.D. Cal. Dec. 10, 2012) (Docket No. 257).

The bondholders asserted that CalPERS, through its motion to lift the automatic stay, is seeking to get preferential treatment and "ignores every other entities' interests." According to the bondholders, permitting CalPERS to litigate and potentially enforce a judgment requiring the payment of post-petition pension obligations would "harm all creditors and put the entire Chapter 9 proceeding at risk." Finally, the bondholders contended that CalPERS "distorts the fundamental principles of bankruptcy law," and misconstrues the 10th Amendment by ignoring the principle that "[s]tate law inconsistent with the City's deferral of payments is preempted rather than violated."

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