Clients&FriendsMemo

City of Stockton: Bankruptcy Court Holds that Rule 9019 Does Not Apply to Chapter 9 Debtors

January 31, 2013

On January 30, 2013, Judge Christopher Klein of the Bankruptcy Court for the Eastern District of California held that, pursuant to section 904 of the Bankruptcy Code, a municipal debtor is not required to seek court approval to enter into settlements with and make settlement payments to prepetition creditors during the pendency of its chapter 9 case. The decision demonstrates the broad scope of section 904 and the free reign that a municipal debtor enjoys under that section during the pendency of its chapter 9 case. *In re City of Stockton, Cal.*, Case No. 12-32118 (Bankr. E.D. Cal. Jan. 30, 2013).

Background

The dispute at issue centered on a proposed settlement with a citizen who had a tort claim against the city's police department for alleged police brutality. The City agreed to pay that citizen $55,000 and, in exchange, the citizen would drop the lawsuit. In October 2012, the City filed a motion requesting that *any* settlement reached between a debtor and creditor need not be approved by the bankruptcy court.

The bondholders challenged the debtor's motion, arguing that Rule 9019 of the Federal Rules of Bankruptcy Procedure applies to chapter 9 and requires that a debtor seek court approval to enter into settlements with creditors. Among other things, the bondholders argued that chapter 9 "is not a one way street," that a debtor should be required to act in good faith during the pendency of its case, and that creditors should have a right to object to these settlements prior to the debtor's filing of its plan of adjustment. Absent such a policing mechanism, the bondholders contended that a municipal debtor would be free to pay its favored creditors prior to even proposing its plan of adjustment, and that unfavored creditors could potentially be left impaired under the plan of adjustment. According to the bondholders, such a result would be inequitable because the debtor could potentially spend all of its revenues to satisfy its favored creditors' claims.

CalPERS and the City both contended that Rule 9019 is not applicable because section 904 of the Bankruptcy Code expressly prohibits the court from interfering with the debtor's use of its property and revenues. Because a settlement payment necessarily involves the debtor's use of its treasury, the City and CalPERS maintained that a settlement and settlement payment would clearly fall within the purview of section 904. Put simply, the City argued that the Court had to "stay out of the city's business." CalPERS and the City also argued that creditors are protected by the provisions of chapter 9 that govern the confirmation of a plan of adjustment and, therefore, it would be premature to afford the creditors a right to object to the debtor's settlements.

Court's Decision

In ruling from the bench, Judge Klein stated that the dispute presented an "interesting, tricky question." The Court determined that the real issue in this case was whether section 904 permits Stockton to enter into settlements and make payments thereunder, notwithstanding the requirements of Rule 9019.

The Court concluded that rule 9019 is not applicable to chapter 9 debtors because of the jurisdictional limitations imposed on the court by section 904. Section 904 provides that, absent the consent of a chapter 9 debtor, a bankruptcy court "may not … interfere with any political or governmental powers of the debtor … [and] any property or revenues of the debtor." According to the Court, a settlement and settlement payment would fall within the purview of section 904 because it would necessarily involve the use of the debtor's property and revenues. Based on the plain language of section 904, the Court determined that a debtor *may* seek court approval and submit itself to the jurisdiction of the court. However, pursuant to section 904, the debtor is not required to seek approval to enter into settlements with creditors.

The Court held that it may only address the terms of a settlement in the context of confirming a plan of adjustment. The Court found that, if the terms of a settlement are indeed unfair, then it would likely cast into doubt the confirmability of the plan of adjustment. The Court pointed to certain provisions of the Code, which it viewed as a source of protection for the bondholders, including (i) section 943(b)(7), which requires that a plan be in the best interests of creditors and be feasible; (ii) section 1129(a)(2), which requires that the "proponent of the plan compl[y] with the applicable provisions of this title"; and (iii) section 1129(a)(3), which requires a debtor to file its plan in good faith. If the Court found that a prospective plan of adjustment violated any of these provisions, Judge Klein stated that he could reject the plan of adjustment and force the City to draft a plan that would be more acceptable. Furthermore, the Court noted that, if a plan of adjustment is not confirmable because the debtor entered into unfair settlements with other prepetition creditors, the bondholders would be permitted to seek dismissal of the case pursuant to section 930(a)(5).

Finally, the Court was not persuaded by the bondholders' policy arguments that they should have the right to dispute and adjudicate settlement terms prior to the confirmation of a plan of adjustment. At the hearing, the bondholders noted that there is a possibility that there will be little to no money left when the City's plan of adjustment is proposed. In such a scenario, there would be no purpose to objecting to the plan. The Court stated that this would be a compelling argument in chapter 11, but not in chapter 9. The Court noted that in chapter 11 there is a distinct possibility that a corporate debtor could be moribund, completely collapse and leave creditors with nothing to recover under a plan of reorganization. In contrast, the Court found that a chapter 9 debtor, particularly one as large as Stockton, would survive and would not collapse, as it can rely on a reliable source of revenue from its citizens.

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

Conclusion

While ultimately consistent with the plain language of the Bankruptcy Code, the decision highlights the tension between the Tenth Amendment safeguards incorporated into chapter 9 and the general equitable principles underpinning other provisions of the Bankruptcy Code. Given creditors' limited ability to challenge a municipal debtor's actions during the pendency of a chapter 9 case, the Court's decision emphasizes the importance of the good faith standards pertaining to eligibility and confirmation.

* * * *

Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

Mark C. Ellenberg	+1 202 862 2238	mark.ellenberg@cwt.com
John J. Rapisardi	+1 212 504 5585	john.rapisardi@cwt.com
Lary Stromfeld	+1 212 504 6291	lary.stromfeld@cwt.com
Douglas S. Mintz	+1 202 862 2475	douglas.mintz@cwt.com
Michael J. Cohen	+1 212 504 6530	michael.j.cohen@cwt.com
Thomas Curtin	+1 202 504 6063	thomas.curtin@cwt.com