

Clients & Friends Alert

Court Holds that San Bernardino is Eligible to File for Chapter 9

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On October 16, 2013, the U.S. Bankruptcy Court for the Central District of California ruled that the City of San Bernardino is eligible for protection under chapter 9 of the Bankruptcy Code. In re City of San Bernardino, Cal., Case No. 12-28006, 2013 WL 5645560 (Bankr. C.D. Cal. Oct. 16, 2013). The Court's decision is an important milestone, as it clarifies that a municipality that does not file a plan with its petition may still meet the Bankruptcy Code requirement that it "desires to effect a plan to adjust [its] debts." The decision also establishes that a city can prove that it met the requirement that prepetition negotiations were impracticable simply by showing that it has a large number of creditors. Both of these rulings may ultimately have significant implications in the pending eligibility dispute in the City of Detroit's chapter 9 case.

The Court's Decision

Over a year after the City filed for chapter 9, the Court held that the City of San Bernardino qualified to be a chapter 9 debtor pursuant to section 109(c) of the Bankruptcy Code.

First, the Court addressed several of the uncontested issues under section 109 of the Bankruptcy Code, including the City's compliance with state law, its insolvency, and whether it negotiated in good faith.¹ The Court found that the City was authorized to file for chapter 9 under applicable California law because the Common Council adopted a resolution declaring a fiscal emergency, as required under California law. The Court also concluded that the City was insolvent because the City faced a cash deficit of \$45.9 million for fiscal year 2012-2013 and accordingly was unable to pay its obligations when the Common Council declared a fiscal emergency.

The Court also found that even though the City did not negotiate with its creditors, such negotiations would have been impracticable. At the eligibility trial on August 28, 2013, the Court stated that a municipality can satisfy the requirements of section 109 if its creditor body is so large

¹ Section 109 of the Bankruptcy Codes requires that, in order for an entity to be a debtor under chapter 9, it must (1) be a municipality, (2) be authorized to file a petition under applicable nonbankruptcy law, (3) be insolvent, (4) desire to effect a plan to adjust its debts and (5) either have obtained creditor consent to a plan, negotiated with its creditors in good faith, without success, or failed to negotiate because negotiation was impracticable.

as to make negotiations impracticable. At the August 28 trial, the Court found that the “impracticability” standard of section 109 is written in such a way “that almost any city with a large number of retirees and trade creditors,” bondholders, and a pension organization like CalPERS would “have no organized way of participating a work-out without otherwise” participating in a bankruptcy proceeding. *In re City of San Bernardino, Cal.*, Case No. 12-28006 (Bankr. C.D. Cal. Aug. 28, 2013). The Court concluded that “any city the size of San Bernardino is going to have a creditor body that is going to be impracticable to negotiate with without the assistance of the bankruptcy process.”

Even though the City had not submitted any plan of adjustment or a term sheet when it filed for chapter 9, the Court nevertheless concluded that the City had a desire to effect a plan of adjustment. Rather, the Court found that section 109 merely requires that a municipality desire to effect a plan of adjustment and that the lack of an early plan is not dispositive as to whether a municipality desires to effect a plan. According to the Court, the analysis under section 109 is highly subjective and “no bright-line text exists for determining whether a debtor desires to effect a plan.”

The Court found that the facts clearly demonstrated that the City desired to effect a plan of adjustment. Among other things, the City implemented various budgets and pendency plans, which impaired certain creditors’ claims. These budgets and pendency plans, according to the Court, “reinforced the reality that the City did not have enough money to pay all of its contracts and would need to impair contracts...in order to achieve a balanced budget.” The Court also noted that the City also took other prepetition measures to impair contracts, including reaching agreements with four of its seven unions on modifications to their collective bargaining agreements. These circumstances, according to the Court, “show that the City began implementation of the steps necessary to restructure its debt” and impair contracts. Thus, the Court found that the City desired to effect a plan of adjustment.

Finally, in examining the totality of the circumstances leading to the City’s chapter 9 filing, the Court found that the City filed its petition in good faith. The Court concluded that the City’s decision to file for chapter 9 “is consistent with the purposes of chapter 9, which is to give a debtor a ‘breathing spell’ so that it may establish a plan of adjustment.” Indeed, the Court noted that in July 2012, the Common Council made official findings that the City would be unable to pay its obligations in the next 60 days and that, given the City’s dire financial condition, it was in the best interest of the City to declare a fiscal emergency. The Common Council based its decision on the belief that the City was insolvent and could no longer pay its employees without impairing contracts. The Court concluded that such facts demonstrated that the City filed for chapter 9 in good faith.

Conclusion

The Court's decision in San Bernardino highlights the growing deference to a municipality's decision to file for chapter 9. Importantly, the San Bernardino decision establishes that a municipality is not required under section 109 to file a plan of adjustment concurrently with its chapter 9 petition, and is only required to desire to effect a plan. The San Bernardino decision may ultimately have a significant impact on the pending eligibility dispute in the City of Detroit's chapter 9 case, where various parties have also raised objections to Detroit's eligibility to file on the basis that Detroit did not desire to effect a plan of adjustment and did not file its plan in good faith. Similarly, various parties have asserted that Detroit failed to negotiate in good faith prior to the bankruptcy. Given the large number of Detroit creditors, the San Bernardino decision, if adopted by the Michigan Bankruptcy Court, would seem to dispose of this issue.

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