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Chapter 9 Municipal Bankruptcy Eligibility Standards Set in *City of Stockton*

The U.S. Bankruptcy Court for the Eastern District of California granted the City of Stockton, California ("Stockton") relief under chapter 9 holding that Stockton satisfied its burden of proof on eligibility under sections 109(c) and 921(c) of the Bankruptcy Code.¹ The court issued its decision, *In re City of Stockton, Cal.*, --- B.R. ---, 2013 WL 2629129 (Bankr. E.D. Cal. June 12, 2013) ("Opinion"), after several days of trial and overruled the objections of capital market creditors. In doing so, the court provided a careful roadmap for chapter 9 eligibility, including analysis of (i) the "good faith" prepetition negotiation requirement under California's gateway statute,² (ii) the requirement that a municipality be "cash" insolvent, (iii) the requirement that a municipality "desire" and "intend" to effect a plan to adjust its debts, and (iv) the requirement that a municipality negotiate with its creditors in good faith before filing.

The Stockton decision is likely to have a significant impact on large chapter 9 bankruptcies.

¹ An entity may be a debtor under chapter 9 if and only if such entity "(1) is a municipality; (2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter; (3) is insolvent; (4) desires to effect a plan to adjust such debts; and (5) (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter; (B) has negotiated in good faith with creditors 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 a plan in a case under such chapter; (C) is unable to negotiate with creditors because such negotiation is impracticable; or (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title." See 11 U.S.C. § 109(c). Even if the foregoing edibility requirements are satisfied, if an objection is filed in the Bankruptcy Court to the petition for relief, "the court, after notice and a hearing, may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the requirements of this title." See *id.* § 921(c).

² In California, a "local public entity . . . may file a petition and exercise powers pursuant to applicable federal bankruptcy law if either of the following apply: (a) The local public entity has participated in a neutral evaluation process pursuant to Section 53760.3 [or] (b) The local public entity declares a fiscal emergency and adopts a resolution by a majority vote of the governing board pursuant to Section 53760.5." See CAL. GOV'T CODE, § 53760 (West 2012). All parties participating in the neutral evaluation process must do so in good faith. See *id.* § 53760.3(o).

The Decision

1. The Facts

Stockton, like so many other municipalities, has suffered substantially in recent years. In February 2012, Stockton's city manager issued a report (the "February 2012 Report") that projected substantial deficits for 2012 and 2013. In the same period, Stockton's independent consultants reported that Stockton was (i) "service delivery" insolvent, meaning that it could not pay the costs of providing basic health, safety, and welfare to the community, (ii) "budget" insolvent, meaning that it could not create a balanced budget to pay projected expenditures, and (iii) on the verge of "cash" insolvency, meaning that it could not maintain cash balances to pay upcoming expenditures. *See id.* at *5.

The February 2012 Report also recommended the initiation of a "neutral evaluation process" to negotiate with creditors (a formal requirement under California law for chapter 9 eligibility). The City Council adopted the recommendation and authorized the suspension of payments from its general fund to pay for three special revenue bonds. The indenture trustee, at the behest of National Public Finance Guarantee Corp. and Assured Guaranty Municipal Corp., which insured the bonds (the "Monolines"), appointed receivers to manage the special revenue projects that supported the bonds. Stockton then participated in a 120-day "neutral evaluation process" and presented a proposed plan of adjustment in the form of an "Ask" to creditors, which included proposals to the Monolines to restructure Stockton's obligations on the special revenue bonds. The Monolines balked at the offer and stated that, unless and until Stockton would impair its pension obligations to the California Public Employees' Retirement System (CalPERS), they would not participate in any further negotiations. *See id.* at *5-6.

Stockton reached an agreement with certain unions whose expenditures represented approximately two-thirds of Stockton's annual budget, but could not reach any agreement with (i) its 2,400 unorganized retirees or (ii) the Monolines. Stockton filed for bankruptcy relief on June 28, 2012. Several parties objected to the petition, including the Monolines, arguing that the case must be dismissed for failure to satisfy the eligibility requirements of sections 109(c) and 921(c) of the Bankruptcy Code.

2. The Ruling

Bankruptcy Judge Christopher Klein methodically applied all of the eligibility requirements of sections 109(c) and 921(c) to the facts surrounding Stockton's bankruptcy petition and concluded that Stockton satisfied each requirement:

- Municipality. The court held that Stockton is a "municipality" under the Bankruptcy Code because it is a political subdivision of California. *See id.* at *7.

- California's Gateway Statute. The court held that Stockton was authorized under California law to file for bankruptcy relief because it pursued a neutral evaluation process in "good faith" by (i) proposing a 790-page "Ask" that was painful to organized labor, (ii) participating in over forty mediation sessions, and (iii) reaching an agreement with certain unions, which represented over 70% of the Stockton's budget. See *id.* at *8. The court held that, "as a matter of California law, serious and productive negotiations with a category of claimants who represent more than two-thirds of a municipality's annual budget independently suffices to satisfy the good faith negotiation requirement of [California Government Code] § 53760.3(o)." See *id.* at *9; see also CAL. GOV'T CODE § 53760 (West 2012).

The court (i) overruled arguments that California's "good faith" negotiation requirement is not reciprocal, holding that parties who walk away from pre-petition negotiations with the municipality may not complain about the negotiating behavior of a municipality, see *Opinion* at *9, and (ii) held that California's gateway statute requires negotiating creditors to pay half of the prepetition negotiation costs as part of the neutral evaluation process notwithstanding any boilerplate provisions in bond indentures that make the municipality responsible for such costs, see *id.* at *10-11.

- Insolvency. The court acknowledged that Stockton was relying on the "unable to pay its debts as they become due" prong of the Bankruptcy Code's test for municipal insolvency (cash insolvency), see 11 U.S.C. § 101(32)(C)(ii), and noted that cash, budget, and service delivery insolvency all inform the insolvency analysis, see *Opinion* at *12. The court noted that a municipality need not be "actually out of cash before it is cash insolvent" because the Bankruptcy Code contains an alternative definition of municipal insolvency that requires the lack of cash. See 11 U.S.C. § 101(32)(C)(i) (a municipality is insolvent if it is "generally not paying its debts as they become due"). The court noted that how far bankruptcy courts must look into the future before a municipality runs out of cash remains an open question, but nonetheless held that, in light of the facts presented in this case, "when a municipality lacks the funds to pay its contractual obligations within the current or the next succeeding fiscal year, it is unable to pay its debts as they become due within the meaning of § 101(32)(C)[(ii)]." See *Opinion* at *13.

In so holding, the court (i) articulated that service delivery and budget insolvency, while not the appropriate tests for determining whether a municipality is insolvent under § 101(32)(C)(ii), aided the court in finding cash insolvency, see *id.* at *14, and (ii) rejected the argument that the municipality must go to the people for a tax increase before filing because the plan of adjustment process contemplates seeking voter-approved tax increases for confirmation, see *id.* at *14-15; 11 U.S.C. § 943(b)(6).

- Desires to Effect an Adjustment Plan. The court held that the statutory phrase “desires to effect a plan to adjust such debts,” see 11 U.S.C. § 109(c)(4), does not actually require that a municipality intend to consummate a confirmable plan because the phrase “subsumes a de facto plan in which a sufficient number of affected parties voluntarily revise their contracts with the municipality in the face of the alternative to potential compulsion of a confirmed plan of adjustment,” see *Opinion* at *16. The court was convinced that Stockton’s decision to unilaterally slash retiree health benefits at the beginning of the case proves that it intends to effect a plan because it would otherwise need to seek a consensual agreement with such retirees to impair their contractual rights in the absence of a plan. See *id.* at *15-16.
- Negotiation. The court (i) held that Stockton negotiated in good faith with each class of creditors, including the unions and the Monolines, (ii) overruled the objection of the Monolines that Stockton did not negotiate in good faith with them because “[i]t is not possible to negotiate with a stone wall,” see *id.* at *17, and (iii) held that Stockton’s restructuring proposal to the Monolines satisfied the good faith requirement because “as a matter of law, a municipality’s section 109(c)(5)(B) good faith negotiation obligation is satisfied with respect to any class of putatively impaired creditors that declines to respond in good faith to a good faith proposal by the municipality,”³ see *id.*
- Good Faith Under Section 921(c). The court (i) held that section 921(c)’s “good faith” requirement only requires municipalities to negotiate in good faith with impaired classes that are willing to negotiate, see *id.* at *18, (ii) noted that the purpose of the “good faith” policy requirement in chapter 9 serves the “policy objective of assuring that the chapter 9 process is being used in a manner consistent with the reorganization process of the Bankruptcy Code,” see *id.*, and (iii) concluded that the relevant considerations for this inquiry include whether a municipality’s “financial problems are of a nature contemplated by chapter 9, whether the reasons for filing are consistent with chapter 9, the extent of [a municipality’s] prepetition efforts to address the issues, the extent that alternatives to chapter 9 were considered, and whether [a municipality’s] residents would be prejudiced by denying chapter 9 relief,” see *id.* at *19.

The court (i) concluded that if a municipality satisfies its burden under § 109(c), there’s a rebuttable presumption that it filed the case in good faith under § 921(c), and (ii) held that the presumption was not rebutted in this case: the “multi-year effort to ratchet down expenses during which [Stockton] reduced employees and reduced employee compensation, its cash insolvency, its service insolvency, its good faith

³ The Court also held that it was impracticable to negotiate with the 2400 unorganized retirees and therefore had no obligation to do so. See *Opinion* at *18; 11 U.S.C. § 109(c)(5)(C).

negotiations or efforts to negotiate with creditors, and its inability to achieve significant further reduction without being able to compel the impairment of contracts,” demonstrates that Stockton acted in good faith. See *id.*

In sum, *In re Stockton* is significant because it demonstrates that municipalities are susceptible to significant litigation in order to obtain an order for relief and become a chapter 9 debtor. As more municipalities file for relief under chapter 9, many of the important issues raised in this case—including potential insolvency fights on day one—may need to be tested.

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