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City doesn't need approval to settle during Chapter 9

By David Kupetz

The cities of Stockton and San Bernardino are debtors in cases currently pending under Chapter 9 of the Bankruptcy Code. Stockton has defaulted on certain bonds and is continuing to make contributions to CalPERS. San Bernardino has suspended its payments to CalPERS. The goal in these cases is confirmation of a Chapter 9 plan restructuring debt.

In the Stockton case, "capital market creditors" (indenture trustee, bond insurer, and bondholder) are seeking to have the case dismissed. Not surprisingly, in the San Bernardino case, CalPERS is seeking dismissal. In both cases, since these cities are suffering from severe financial distress, dismissal appears unlikely so long as the debtors proceed forward in good faith to develop and present a fair and feasible plan of debt adjustment.

One dramatic difference of Chapter 9 from other bankruptcy cases is that the jurisdiction and power of the bankruptcy court over the municipal debtor is severely limited. Unless the municipal debtor consents, the court is precluded from interfering with (1) any of the political or governmental powers of the debtor, (2) any property or revenues of the debtor, and (3) the debtor's use or enjoyment of any income producing property. These limitations are designed to preserve the constitutional balance between the federal bankruptcy power and state sovereignty.

In bankruptcy cases for nongovernmental entities, notice to creditors and court approval are necessary for the debtor to effect and fund a settlement or compromise. Such approval requires both compliance with the procedural requirements and that the proposed compromise is fair and equitable. Chapter 9, however, only incorporates portions of otherwise generally applicable provisions of the code and certain parts of the bankruptcy rules do not apply in Chapter 9 cases.

The bankruptcy court presiding over Stockton's Chapter 9 case issued a written opinion on Feb. 5 ruling, over the objection of capital market creditors, that a municipal debtor does not need court approval to settle claims during a Chapter 9 case. Further, the bankruptcy court explained that without the municipality's consent, the court is precluded from interfering with the city's property or revenue and, therefore, could not disapprove a proposed settlement.

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The court warned that the day of reckoning would come when the city comes before the court for approval of its Chapter 9 plan of debt adjustment.

The issue arose in the Stockton case when the city agreed to settle a pending damages lawsuit for \$55,000. The city brought a motion asking the court to determine that in a Chapter 9 case court approval of a settlement or compromise entered by the debtor is not necessary.

Only in the event that the court ruled that its approval was mandatory, the city requested the court's approval of the subject compromise. While conceding that the proposed settlement was likely to pass judicial scrutiny under the usual "fair and equitable" standard, the capital market creditors contended that the city was required to obtain court approval.

The amount of the compromise at issue was relatively insignificant. Moreover, the fees incurred by the parties litigating the issue may have collectively approached or exceeded the amount of the settlement. However, the real issue of concern was whether any limiting principles apply to the

conduct and activities of a Chapter 9 debtor prior to confirmation of a plan of debt adjustment.

The bankruptcy court specifically held that Stockton was free to spend \$55,000 settling a lawsuit without its permission. The court found that the power to approve would imply the power to disapprove. Disapproval of the compromise would interfere with the city's property or revenues. Congress precluded such interference in Chapter 9 cases. Accordingly, the court ruled that "the City can expend its property and revenues during the chapter 9 case as it wishes" and "can pay any debt in full without permission of this court."

The bankruptcy court discussed that the municipal debtor may consent to judicial interference. Examples cited by the court of situations where a Chapter 9 debtor may choose to consent to judicial approval of a compromise or settlement include (1) a counterparty requiring approval as a condition to the settlement, (2) a municipality pursuing a strategy of transparency to eliminate or minimize future plan objections, and (3) a municipality seeking to satisfy some requirement of a nonbankruptcy law that could be satisfied through bankruptcy court approval.

The bankruptcy court explained that the real limitations on a municipal debtor are imposed indirectly through the overall Chapter 9 process. The debtor's goal is to obtain court approval of its plan of debt adjustment. In a Chapter 9 case, the municipal debtor has the exclusive right to propose a plan and bears the burden of proving that the requirements for confirmation have been satisfied. It is essential that a municipal debtor understand that overreaching on its part during the course of a Chapter 9 case may make it difficult to confirm a plan.

The code and the court do not restrict the post-Chapter 9 operations of a municipality.

Nonetheless, the municipality must weigh its ongoing operations

and actions against the need to show that Chapter 9 was a necessary last resort and that it is moving forward in good faith to develop a feasible and fair plan of debt adjustment. While there may be disputes with creditors regarding what are essential ongoing services and programs, without the municipal debtor's consent, the court is not to address those matters prior to considering the debtor's plan of debt adjustment.

In the Stockton case, the court identified plan confirmation requirements that could be difficult for a debtor that makes untoward settlements during the course of the case to satisfy.

A Chapter 9 plan must be proposed in good faith. Further, creditors are divided into classes that vote on a plan. If any class of creditors does not vote to accept a plan, the plan must not discriminate unfairly and must be fair and equitable with respect to any nonaccepting, impaired class. A debtor that entered nefarious settlements prior to presenting a plan could likely be unable to satisfy these requirements.

The bankruptcy court concluded that the limiting principle and protection to which the capital market creditors of Stockton are entitled is their right to oppose a plan of debt adjustment presented by the city. At the same time, the city is on notice that its creditors reserve the right to litigate the debtor's spending choices and management throughout the case at the time of plan confirmation.

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