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PERSPECTIVE

Stockton creditors chastised

By David Kupetz

Chapter 9 of the bankruptcy code provides a framework for eligible governmental entities to restructure debt. The underlying intent is to enable a local public entity that is unable to pay its debts as they come due to continue to provide essential services to residents while working out a plan to adjust its debts. The goal of a Chapter 9 case is the adjustment of debts necessary for the local public entity to achieve financial sustainability. Moreover, without court approval of a Chapter 9 plan, a municipality lacks constitutional authority to compel impairment of contracts.

The city of Stockton filed a voluntary petition commencing its Chapter 9 case on June 28, 2012. Since the inception of the case, “capital market creditors” (indenture trustees, bond insurers and bondholders) have sought its dismissal by arguing that the city is not eligible for Chapter 9 relief. As the bankruptcy court presiding over the Stockton case explained in an exhaustive opinion issued on June 12, 2013, when opposition to relief is present, “Chapter 9 is unique among voluntary Bankruptcy Code cases in that a municipality must litigate its way to the order for relief before restructuring its debt.” *In re City of Stockton*, No. 12-32118-C-9 (E.D. Cal.).

Chapter 9 is designed to balance the powers provided under federal bankruptcy law to restructure a municipality’s debt against the mandate of the 10th Amendment to the U.S. Constitution guaranteeing state sovereignty. The bankruptcy code embodies this balance by requiring that states authorize their municipalities to file Chapter 9 cases and imposing other eligibility requirements, including that the municipality be “insolvent” and have a good faith desire to effect a plan to adjust its debts. The capital market creditors contended that Stockton did not fulfill the conditions necessary for it to be authorized for Chapter 9 relief, was not insolvent, and did not have a good faith desire to effect a plan.

The court’s recent opinion in the Stockton case addresses Chapter 9 eligibility issues that arose during a 3-day trial. California law governs the question of whether Stockton is authorized to be a Chapter 9 debtor. California’s gateway statute to Chapter 9, commonly referred to as AB 506, was enacted as of Jan. 1, 2012. California Government Code Section 53760 authorizes municipalities to be Chapter 9 debtors by either pursuing a neutral evaluation (mediation) process or declaring a fiscal emergency.

The court held that the refusal of the capital market creditors to pay their share of the California neutral evaluation process constitutes an independent basis for rejecting their objection to Stockton’s compliance with the California gateway statute.

Stockton pursued the neutral evaluation process. The process was presided over by a retired bankruptcy judge and lasted the maximum 90 days permitted by statute. There were more than 40 sessions with various interested parties. Agreements were reached with some of the participating parties, including all unions with unexpired collective bargaining agreements. The capital market creditors, however, only attended two meetings with the neutral evaluator, took the position that there was nothing to talk about, and declined to participate further.

The capital market creditors asserted that, as a matter of state law, Stockton did not satisfy its good faith negotiation obligation during the AB 506 process. First, they argued that because the city had not proposed to impair its pension obligations to the California Public Employees’ Retirement System (CalPERS), any proposal to impair their rights was not made in good faith. Second, they contended that Stockton’s proposal was made on a take-it-or-leave-it basis without the intention of actually negotiating. Further, despite the requirement under California law that the local public entity pay only 50

percent of the costs of the neutral evaluation process and that creditors pay the balance, the capital market creditors declined to pay anything. Instead, they argued that the boilerplate provisions in the bond indenture contracts imposed on the city the responsibility for the creditors’ legal expenses in this Chapter 9 battle.

While the issue of whether the city should be more aggressively seeking to modify its obligations to pensioners is an issue that relates to the structure of a confirmable plan, it is not relevant to eligibility for Chapter 9 relief. The court found that the capital market creditors “inappropriately used an issue [the lack of proposed impairment of obligations to CalPERS] relating to plan confirmation, but that is irrelevant to eligibility, as a pretext to decline to negotiate in good faith and to force a trial that should not have been necessary.” Further, the court concluded that since the creditors “adopted the posture of a stone wall by refusing seriously to negotiate, [they] will not now be heard to complain about the negotiating behavior of their counterparty.”

The court held that the refusal of the capital market creditors to pay their share of the California neutral evaluation process constitutes an independent basis for rejecting their objection to Stockton’s compliance with the California gateway statute. The court found that, in the context of the neutral evaluation process, California law was designed to trump fee-shifting provisions in order to promote negotiation. The court harshly stated that “the decisionmakers for the capital market creditors need to check their testosterone at the door, stop assuming that they are spending their opponent’s money when they direct their counsel to pursue wasteful legal tasks, and make their litigation business decisions on the premise that they will be responsible for every dollar of legal effort that they order.”

A local public entity that is unable to pay its debts as they come due is “insolvent” for purposes of Chapter 9 eligibility. The capital market creditors

contended the city’s insolvency was engineered and not genuine. The court determined Stockton is unable to pay its debts as they come due (“cash insolvency”). A local public entity need not actually be out of cash to be cash insolvent. The court held that “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 come due” for purposes of Chapter 9 relief. The court further concluded that the city’s “service delivery insolvency” (inability to fund essential governmental services) confirmed that the cash insolvency was real and that the city’s “budget insolvency” (projected long-term budget imbalances) demonstrated that insolvency would continue without realignment of revenues and expenses.

Addressing the issue of the city’s good faith desire to effect a plan, the court found that Stockton had engaged in extensive efforts to resolve claims and had implemented unilateral cost-cutting measures at the outset of its Chapter 9 case. As a result, the court concluded that Stockton “committed itself to the goal of either confirming a Chapter 9 plan or achieving agreements sufficient to constitute a de facto plan with respect to the victims of its measures.” While concluding that Stockton possessed the requisite good faith, the court held that the capital market creditors had not negotiated in good faith and had further demonstrated a lack of good faith by opposing Chapter 9 relief when they must have recognized that the desperate financial straits of the city could only be solved by impairing contracts through the Chapter 9 process.



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