

# A Guide to Municipal Bankruptcy for City Attorneys

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# What is Municipal Bankruptcy?

- Protection from creditors/Provision of essential services/Development of debt restructuring plan
- First enacted during Great Depression
- 10th Amendment prohibits interference with a city's powers, revenues, and property
- Limited court and creditor powers: No trustee, court ordered liquidation, etc.
- Many chapter 11 provisions incorporated into chapter 9 - see executory contracts and plan confirmation

# Financial Problems That Could Lead to Bankruptcy

- Structural issues or a single event
- Single events: investment losses (Orange County) and large judgments (Desert Hot Springs, Mammoth Lakes)
- From structural issues: San Bernardino, Stockton, Vallejo, Detroit, Puerto Rico
- CA cities largest structural issue: rising pension contributions
- Other issues:
  - Flat or declining revenues
  - Rising Costs
  - Bond debt
  - Liability from lawsuits
  - Management problems or inadequate financial controls

## Notable Municipal Bankruptcies

Municipality	Year	Primary Reason
Orange County, CA	1994	Investment losses
Desert Hot Springs, CA	2001	Large judgment
Vallejo, CA	2008	Pension obligations and labor costs
Jefferson County, AL	2011	Sewer system bonds
Stockton, CA	2012	Bond debt and retiree healthcare
San Bernardino, CA	2012	Liquidity crisis, labor costs and pensions
Mammoth Lakes, CA	2012	Large judgment
Detroit, MI	2013	Population loss and bond debt
Puerto Rico	2017	Bond debt and insolvent pension system

# Avoiding Bankruptcy

- Evaluate finances and unrestricted funds
- Develop financial and operational plans
- Engage with stakeholders (also prerequisite to bankruptcy)
  - Including CalPERS, unions, bondholders, financial institutions, retiree representative, plaintiffs
  - Possibility of chapter 9 encourages negotiation
- Prepare summary chapter 9 plan or term sheet
- Engage experienced professionals/Form bankruptcy team
- City attorney often key point of contact with professionals

# Eligibility to File for Bankruptcy Protection

- To be eligible, must:
  - Be a municipality
  - Be authorized under state law and meet any state requirements
    - In CA under AB 506, either engage in “neutral evaluation process” (i.e. mediation) or declare a fiscal emergency
  - Be insolvent
  - Desire to effect a plan of adjustment
  - Negotiate with creditors or show negotiations would be impracticable
  - Show that petition was filed in good faith

San Bernardino suddenly discovered it was out of cash/Could not negotiate with creditors/Declared fiscal emergency

## Beginning of a Chapter 9 Case

- Filing petition triggers “automatic stay” of actions
- Creditors often contest eligibility
- CalPERS fought San Bernardino's eligibility, but bankruptcy court rejected challenge
- Role of city attorney:
  - Coordinate with city and bankruptcy counsel on legal matters
  - Manage Communications/Confidentiality/Privilege
  - Address municipal law issues

San Bernardino city attorney was spokesperson on legal matters and assisted in BK court proceedings



# Treatment of Pensions

- Pensions protected as "vested rights" under California Rule
- Detroit (and Stockton): "pension rights are contractual rights . . . subject to impairment."
- Stockton: agreements with CalPERS can be "rejected"/General unsecured claim for damages
- But Stockton did not reject CalPERS agreement

San Bernardino affirmed CalPERS obligations/Lowered pension costs through collective bargaining agreement changes (e.g., eliminating the employer made member contribution) and other measures

## Rejection of CBAs

- Collective bargaining agreements (“CBAs”) are executory contracts
- May reject if:
  - CBA burdens the debtor;
  - Equities favor rejection; and
  - Made reasonable efforts to negotiate, and prompt and satisfactory solution unlikely.

# Unilateral Modification of CBAs and Retirement Benefit Obligations

- Before rejection, may unilaterally suspend/modify CBA
- Need not follow procedure of state labor laws (e.g., negotiation to impasse)
- May also unilaterally suspend/modify retiree health benefit obligations
  - Losses may be treated as general unsecured claims

San Bernardino unilaterally imposed changes to CBAs/Made the changes permanent upon rejection/Also reduced retiree healthcare benefit obligations

# Treatment of Bonds

- General obligation bonds
  - Not secured by a particular stream of income
  - Can be heavily impaired (but SB 222 may provide protections for CA GO bonds)

San Bernardino treated its pension obligation bonds as unsecured. After litigation, settled with bondholders for a significant discount.

- Special revenue bonds
  - Secured by specific revenue source
  - Enhanced protections in bankruptcy
  - Liens continue on special revenues arising during case
  - But some limitations on rights (e.g., revenue may be used for project operating expenses)

# Mediation and Litigation with Stakeholders

- Bankruptcy court often orders parties to mediation
- Mediator typically a bankruptcy judge
- May be powerful influence over case and parties

San Bernardino reached agreements with major creditor constituencies through mediation/City attorney intimately involved in process

- Bankruptcy court can decide disputes/Including issues of state law, if critical to confirmation of plan

Firefighters union challenge over contracting out/Bankruptcy court interpreted city charter to reject challenge

# Exiting Bankruptcy: The Plan of Adjustment

- Ultimate goal of case: confirm plan of adjustment
- Provides treatment of classes of claims and means of implementation  
For San Bernardino, means included operational reforms, outsourcing services, charter reform, and new revenue
- Debtor submits plan (and disclosure statement) to creditors for vote
- Bankruptcy court considers whether plan meets Bankruptcy Code requirements
- Plan must be, among other things:
  - Feasible
  - In the best interests of creditors
  - Accepted by all impaired classes or “crammed down” on dissenting impaired classes

# Cramdown

- For cramdown on dissenting class, plan must: be fair and equitable and not discriminate unfairly
- Unsecured claims may often be heavily impaired

San Bernardino's plan paid general unsecured claims at 1%. Ultimately consented to by all impaired creditor classes.

Plan included an injunction in favor of nondebtor officers and employees, restricting plaintiffs' ability to pursue litigation/Compulsory ADR procedures

- Secured claims also may be impaired/Less so than unsecured/Constitutional protection

# Pros and Cons of Bankruptcy

## PRO

- Automatic stay against creditors
- A single forum to resolve disputes
- Prompt resolution of issues (may include state law) by bankruptcy judge
- Ability to suspend and reject CBAs
- Adjustment of debts through a bankruptcy plan

## CON

- Expense of filing and managing case
- Time and attention of staff
- Negative perception
- Reaction of capital markets



## Key Takeaways for City Attorneys

- Recognize financial problems (and hire experienced professionals early).
- Eligibility usually requires substantial preparation before bankruptcy/Development of plan outline/Negotiation with creditors.
- So, preparing for possible bankruptcy is often the best way to avoid it.
- Mediation may be an important vehicle to achieve settlements before and during case.
- City may be able to reject CBAs and impair pensions obligations, retiree health benefit obligations, bonds and litigation claims upon appropriate showings.
- Through plan, city may be able to achieve substantial debt reduction/Lowering of expenses/Restructuring of operations.