Lessons from the San Bernardino Bankruptcy for City Attorneys

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A Guide to Municipal Bankruptcy for City Attorneys

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Introduction

Throughout California, cities' operating costs are growing faster than revenue. Increased pension costs are a primary driver of this growing crisis, though many cities face other pressures as well. Against this background, there is heightened interest in municipal bankruptcy under chapter 9 of the United States Bankruptcy Code.

A chapter 9 bankruptcy is a judicial proceeding that gives a municipality breathing room to operate and provide uninterrupted public services while formulating a plan to restructure its debts. Filing a bankruptcy petition immediately stops all collection actions against the debtor and its property. The end goal of a chapter 9 case is to confirm a plan of adjustment, which modifies the debtors' debts and obligations in accordance with the Bankruptcy Code and other applicable law.

A basic knowledge of chapter 9 may be helpful even for cities who never actually file for chapter 9 bankruptcy relief, as the possibility of bankruptcy can assist efforts to restructure and guide negotiations with stakeholders. This paper provides a brief overview of important municipal bankruptcy topics, with a particular emphasis on those relevant to city attorneys and illustrations from the bankruptcy of the City of San Bernardino. The first section discusses the challenges facing California cities and actions that may help a troubled city avoid bankruptcy. The second section summarizes the eligibility requirements under chapter 9, including the practical steps cities must take before they undertake a chapter 9 filing. The third section offers an overview of the administration of a chapter 9 case, from the preparation stage through the confirmation of a plan of adjustment. The final two sections provide a summary of the pros and cons of a chapter 9 bankruptcy and a list of key takeaways for city attorneys.

Please note that this paper is intended only as an overview of key issues. It is not a complete discussion of the law of chapter 9 bankruptcy and does not purport to be legal advice or an instruction manual. If at all possible, cities in financial distress should engage experienced insolvency counsel and financial advisors long before considering the commencement of a chapter 9 case.

I. Avoiding Bankruptcy

A. Financial Problems That May Lead to Bankruptcy

A city may find itself facing chapter 9 bankruptcy because of long-term structural problems or because a single event suddenly renders the city insolvent. The largest municipal bankruptcy in California history, Orange County, was caused by an unexpected $1.7 billion loss to investments in risky derivatives. *In re County of Orange*, 183 B.R. 594, 598 (Bankr. C.D. Cal. 1995). For the City of Desert Hot Springs and the Town of Mammoth Lakes, the one-time event was a large judgment entered against the city. *Silver Sage Partners, Ltd. v. City of Desert Hot Springs (In re City of Desert Hot Springs)*, 339 F.3d 782, 787 (9th Cir. 2003); *In re Town of Mammoth Lakes*, No. 2:12-bk-32463 (Bankr. E.D. Cal. 2012).

The three most recent bankruptcies of large California cities were caused by structural factors in the wake of the 2007-08 financial crisis. Before the crisis, most cities enjoyed rising property values and tax revenues. When pension fund portfolios were increasing and credit market conditions were favorable, cities could borrow money relatively easily. When the bubble burst, all of those positives turned into negatives. Property values, tax revenues, and pension fund assets fell while labor and pension costs continued to rise. This led to budget shortfalls and underfunded pension liabilities, while a tightening credit market reduced access to borrowing. That perfect storm challenged many cities, and it drove Vallejo, Stockton, and San Bernardino into bankruptcy.

San Bernardino was hit particularly hard by the national collapse of the housing market. The city's population grew during the real estate boom, leading to more public services and, consequently, more city employees. After the collapse, the city's property and sales tax revenues declined steeply, but personnel costs continued to rise. The city offered more generous retirement benefits than most California cities, including higher employer pension contributions, and the city charter set police officer and firefighter salaries by formula. These and other factors left San Bernardino with high labor costs, comprising approximately 75% of annual general fund expenditures, and little room to generate savings. Worse, the city did not realize the true urgency of its problems until it was on the verge of running out of cash, leading to an emergency bankruptcy filing.

More recently, structural factors drove both Detroit's 2014 chapter 9 filing and the still-unfolding restructuring of Puerto Rico under the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA, codified at 48 U.S.C. § 2101, *et seq.*). *In re City of Detroit*, 504 B.R. 191 (Bankr. E.D. Mich. 2013; *In re City of Detroit*, 504 B.R. 191 (Bankr. E.D. Mich. 2013); *In re Fin. Oversight & Mgmt. Bd.*, No. 17 BK 3283-LTS, 2018 U.S. Dist. LEXIS 117348 (D.P.R. July 13, 2018).

Today, California cities are facing mounting fiscal pressures, with little sign of relief on the horizon. Rising pension costs are of particular concern, driven by the confluence of several factors. The California Public Employees' Retirement System ("CalPERS") and other pension funds performed below expectations in recent years, particularly during the financial crisis. In December 2016, CalPERS voted to its lower expected investment return from 7.5% to 7% by 2020, requiring public employers to make up the resultant increase in unfunded liability. Meanwhile, life expectancy has continued to increase, producing longer periods for which benefits must be paid to retirees.

Ever-increasing contribution requirements will place steadily greater burdens on cities' general funds. According to a recent League of California Cities report, cities expect to spend an average of 15.8% of their general fund budgets on pensions by fiscal year 2024-25, up from the current average of 11.2%. In fiscal year 2006-07, the average was 8.3%. *League of California Cities Retirement System Sustainability Study and Findings*, January 2018, at 4.[2]

Other personnel costs place financial pressure on cities too. The same life expectancy changes that drive increased pension costs also increase the cost of other post-employment benefits, namely retiree health care. The cost of providing healthcare to current employees continues to rise as well. In addition, cities may face unsustainable debt burdens from bonds issued under different economic conditions.

Against increased costs, some cities face flat or even declining revenues. The California Constitution's requirement that cities receive voter approval for higher taxes limits the ability to raise revenue. There may be limited appetite for tax increases, as many cities facing financial distress already have high tax rates. A future economic slowdown could well force some cities to seek bankruptcy relief.

B. Identifying Financial Challenges and Developing a Fiscal Plan to Address Them

For a city seeking to avoid bankruptcy, the first step is to clearly evaluate its financial picture, including the factors driving the city into insolvency. In some distressed cities, financial controls and reporting systems may slip, obscuring the depth and nature of financial problems. One particular risk is that, if funds are not tracked closely, a distressed city may run afoul of limitations on the use of restricted funds as it depletes its general fund cash. Also, if a municipality has publicly traded securities, it may be obligated to make disclosures related to its financial condition.

After diagnosing the problems, the next step is to develop detailed financial and operational plans to restore the city to health. While finding solutions may be difficult, cities that take on their structural problems proactively will fare better than the cities that wait. In fact, as we will see later, in determining whether a California city is even eligible for chapter 9 protections and debt relief, a bankruptcy court will likely require that such preliminary pre-bankruptcy efforts be made. Measures may include outsourcing or reducing services, renegotiating employee salaries and benefits, restructuring financial debt, or raising taxes or other revenue.

Financial advisors and bankruptcy counsel can provide crucial assistance both in identifying problems and finding solutions. Unfortunately, it is all too common for restructuring professionals to be brought in too late—the earlier they start, the greater the chance of success, and the less painful the process in the long run. The city attorney can be instrumental in identifying the need for professionals and participating in the selection process.

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[2] The report is available at: https://www.cacities.org/Resources-Documents/Policy-Advocacy-Section/Hot-Issues/Retirement-System-Sustainability/League-Pension-Survey-(web)-FINAL.aspx (accessed Aug. 3, 2018).

C. Engaging and Obtaining Concessions from Stakeholders

To achieve its restructuring goals, a city will have to negotiate with and obtain concessions from stakeholders, who will be asked to “buy in” to the city’s proposals. Stakeholders generally include unions, CalPERS, retired employees, bondholders, financial institutions, litigation plaintiffs, and other major creditors. Those stakeholders will require financial information necessary to respond to the city’s proposals.

For cities in significant distress, stakeholders should be aware that a city may have to file for bankruptcy if an agreement cannot be reached. The possibility of bankruptcy and likely outcomes may encourage all sides to negotiate constructively toward a solution, and temper the parties’ negotiating positions. So, ironically, preparing for a bankruptcy filing may be the best way to avoid one. This makes it all the more important to engage professionals with a deep understanding of chapter 9 as soon as practically possible.

To aid negotiations, the city should prepare a summary plan of adjustment or term sheet, supported by detailed projections. The proposal must explain what creditors would receive and how the plan will be carried out. The proposal will communicate the gravity of a city’s situation and provide a useful reference point for what can often be complex, multilateral negotiations. If the city ultimately does file for bankruptcy, as discussed in more detail below, the conduct, extent and duration of negotiations with creditors may be key issues in the determination of whether the city is eligible to be a chapter 9 debtor. Every step of the negotiations should therefore be documented in preparation for a contested hearing or trial on eligibility.

II. Requirements to Become an Eligible Chapter 9 Debtor

Eligibility for chapter 9 protection and debt relief is often an early flashpoint in a chapter 9 case. A debtor must prove its eligibility to be a chapter 9 debtor, and creditors may object vigorously because their leverage may decline precipitously if eligibility is established. Accordingly, the trial or contested hearing over eligibility and related proceedings can be long, contentious affairs. The city attorney will participate in these proceedings and collaborate with bankruptcy counsel, as he or she will for other matters in the case.

The bankruptcy court may review in minute detail the sources and uses of the city’s revenues and the constraints on the city’s ability to apply certain restricted funds to general obligations. A municipality’s conduct in the period preceding bankruptcy, including its negotiations with each stakeholder, may also come under close scrutiny. Accordingly, preparation for a fight over eligibility should begin well before the petition is actually filed.

There are essentially six requirements for a municipality to be eligible to file under chapter 9:

i. a debtor must be a municipality;

ii. it must be specifically authorized by state law to file chapter 9 (and meet any additional requirements imposed by the state);

iii. it must be insolvent;

iv. it must desire to effect a plan to adjust its debts;

v. it must either (a) obtain majority agreement of each class of claims affected by its plan, (b) have negotiated in good faith but failed to obtain such an agreement, (c) show that negotiation would be impracticable, or (d) reasonably believe that creditor may attempt to obtain a preferential payment; and

vi. it must prove that it filed the petition in good faith.

The first five requirements are listed in section 109(c) of the Bankruptcy Code; section 921(c) provides the sixth. 11 U.S.C. §§ 109(c), 921(c).

A. Definition of "Municipality"

Turning to the first requirement, only a "municipality" can file under chapter 9. The term "municipality" is defined as a "political subdivision or public agency or instrumentality of a State." 11 U.S.C. § 101(40). Cities, counties, and townships will generally fall within the definition of "political subdivision." "Public agency or instrumentality of a State" may include a wide variety of entities, such as school and hospital districts, sanitation and irrigation districts, public improvement districts, boards, commissions, and authorities, as well as certain revenue-producing bodies that provide services paid for by charges or tolls rather than taxes. Indeed, most municipal debtors are these other types of public entities, although cities and counties get the most attention.

B. State Authorization to File

In deference to the powers reserved to the states under the Tenth Amendment of the United States Constitution, the Bankruptcy Code confers upon each state the absolute right to act as a gatekeeper to decide whether to permit its municipal entities to file under chapter 9. Some states have a broad enabling statute, but others impose additional requirements, such as obtaining permission of the governor. Conn. Gen. Stat. Ann. Sec. 7-566. Approximately half of the states have no authorizing statute at all, and a specific law must be passed to allow a filing.

Until 2011, California allowed its municipalities to file for bankruptcy without meeting any additional requirements. That changed in 2011, when California enacted Assembly Bill No. 506 (codified at Cal. Gov't Code § 53760). Now, to be authorized to file for chapter 9, a California municipality must first either pursue a neutral evaluation process or declare a fiscal emergency.

1. Neutral Evaluation Process

The neutral evaluation process is a mediation among the municipality and "interested parties" that conforms to the statutory requirements of California Government Code § 53760.3. The "interested parties" must include any union, major creditor, or pension fund, among others. Cal. Gov't Code § 53760.1(e). All participants are required to negotiate in good faith, and the process is to be kept confidential, unless all parties expressly agree to disclosure or a bankruptcy judge later needs the information to determine whether the municipality is eligible for chapter 9. Cal. Gov't Code § 53760.3(q). The process is to last 60 days but may be extended by an additional 30 days. Cal. Gov't Code § 53760.3(r).

The neutral evaluator (essentially a mediator) is selected by the participants and may ask for documentation and other information, such as "the status of funds of the local public entity that clearly distinguishes between general funds and special funds, and the proposed plan of readjustment prepared by the local public entity." Cal. Gov't Code § 53760.3(k). Because of those information requirements, it is imperative that a municipality enter the neutral evaluation process with financial transparency and with a well-developed "ask" in the form of a proposed plan of adjustment.

The City of Stockton engaged in neutral evaluation processes before filing for chapter 9. It entered with a detailed proposed plan of adjustment that impaired bondholders and included "painful cuts to organized labor." *In re City of Stockton*, 493 B.R. 772, 782-85 (Bankr. E.D. Cal. 2013). The city reached agreements with its labor unions, but its capital markets creditors refused to negotiate and did not pay any costs of neutral evaluation. *Id.* at 786. The bankruptcy court concluded that Stockton had fulfilled the neutral evaluation requirement because the capital markets creditors had refused to negotiate in good faith.

2. Declaration of Financial Emergency

The other route into bankruptcy is to declare a financial emergency. To do so, it must adopt "a resolution by a majority vote of the governing board at a noticed public hearing that includes findings that the financial state of the [municipality] jeopardizes the health, safety, or well-being of the residents . . . absent the protections of Chapter 9." Cal. Gov't Code § 53760.5. The resolution must include findings that the public entity is or will be unable to pay its obligations within the next 60 days. The municipality must also take public comment at a noticed public hearing on its fiscal condition. *Id.*

The City of San Bernardino was forced to take this path. While the city had faced structural issues for some time, the depth of the city's liquidity crisis was obscured by understaffing and turnover in its finance department. When a new finance director stepped in, he discovered that the city was unable to meet even its current obligations, which necessitated an emergency chapter 9 filing. *In re City of San Bernardino*, 499 B.R. 776, 779-80 (Bankr. C.D. Cal. 2013). As a result, San Bernardino entered bankruptcy without complete financials, a proposed plan of adjustment, or agreements with any key stakeholders, all of which made the case considerably more challenging.

C. Insolvency

To be an eligible chapter 9 debtor, a municipality must be insolvent, which is generally determined on a cash-flow basis. A debtor is insolvent if is not paying undisputed debts as they come due or will be unable to pay debts based on projections for the current or next succeeding fiscal year. *In re City of Vallejo*, 408 B.R. 280, 290 (B.A.P. 9th Cir. 2009); *In re City of Stockton*, 493 B.R. 772, 789 (Bankr. E.D. Cal. 2013).

Bankruptcy courts have also considered whether a municipality is "service-delivery insolvent," *i.e.*, unable to provide services "at the level and quality that are required for the health, safety, and welfare of the community." *Stockton*, 493 B.R. at 789 (Bankr. E.D. Cal. 2013); *In re City of Detroit*, 504 B.R. 191, 263 (Bankr. E.D. Mich. 2013); *In re City of San Bernardino*, 499 B.R. 776, 787 (Bankr. C.D. Cal. 2013) (describing budget cuts' negative impact on services and safety). In *Stockton* and *Detroit*, the bankruptcy courts determined that the respective cities were both cash-flow and service-delivery insolvent. Both decisions highlighted rising crime levels as the crucial factor in service-delivery insolvency; the cities could not afford to adequately invest in their police forces unless their debts were adjusted in a bankruptcy proceeding. The *Stockton* court also noted that the city could not count on a tax increase to fund its police force, because the requirement for voter approval rendered any such measure uncertain.

No court has yet found that a municipality is insolvent based on service-delivery insolvency alone, without cash-flow insolvency. A municipality with burdensome long-term obligations must still be prepared to make the requisite showing of cash-flow insolvency in the short term.

D. The Debtor's Desire to Effect a Plan, Good Faith, and Efforts to Negotiate

The last three chapter 9 eligibility requirements are similar.

The fourth requirement is that the municipality "desires to effect a plan to adjust" its debts. 11 U.S.C. § 109(c)(4). This means that the filing must not simply be to buy time or thwart creditors.

The fifth requirement is that the debtor must satisfy one of four conditions. It must either:

i. have obtained the consent of a majority of each of its impaired classes ;

ii. failed to obtain such consent after negotiating in good faith;

iii. be unable to negotiate because it would be impracticable; or

iv. reasonably believes a creditor may attempt to obtain a transfer that is avoidable as a preference.

11 U.S.C. § 109(c)(5). Whether a municipality has negotiated in good faith with its creditors is an oft-litigated issue.

To demonstrate good faith, a municipality should present creditors with a specific plan of adjustment. *In re City of Detroit*, 504 B.R. 191, 267 (Bankr. E.D. Mich. 2013). Creditors should be given sufficient time to respond, and constructive creditor counterproposals should receive genuine consideration. However, a municipality need not offer concessions to creditors who refuse to negotiate, nor accept a proposal that provides short-term relief but merely delays an inevitable filing. *In re City of Vallejo*, 408 B.R. 280, 297 (B.A.P. 9th Cir. 2009); *In re City of Stockton*, 493 B.R. 772, 793 (Bankr. E.D. Cal. 2013).

In some cases, negotiating with some or all creditors will be impracticable. In both *Stockton* and *Detroit*, negotiating with retirees was held to be impracticable because there was no representative who could bind thousands of individuals to an agreement. *Stockton*, 493 B.R. at 794; *Detroit*, 504 B.R. at 194. San Bernardino's sudden discovery of its financial emergency made pre-bankruptcy negotiations impracticable. *In re City of San Bernardino*, 499 B.R. 776, 786 (Bankr. C.D. Cal. 2013).

The sixth requirement is that the debtor filed the petition in good faith. 11 U.S.C. § 921(c). Factors relevant to the court's good faith determination include whether the debtor's actions are consistent with chapter 9, the breadth and depth of the debtor's financial problems, and the extent of the debtor's prepetition negotiations and consideration of alternatives to chapter 9. *San Bernardino*, 499 B.R. at 790.

In *San Bernardino*, CalPERS alleged that the city did not have the desire to effect a plan and did not file its petition in good faith. *San Bernardino*, 499 B.R. at 778. The bankruptcy court rejected both arguments, because it found that the city's filing was consistent with the purposes of chapter 9: "to give a municipality a breathing space from a cash crunch and an opportunity to address its long term solvency through an organized process of proposing a long term plan of adjustment." *Id.* at 791. The court acknowledged that San Bernardino did not meaningfully negotiate with creditors or consider alternatives to chapter 9 but, under the circumstances, the city had no reasonable alternative other than an emergency chapter 9 filing. *Id.*

III. The Chapter 9 Case

A. Preparation for Filing

A chapter 9 case is commenced by the filing of a petition under section 301 of the Bankruptcy Code. 11 U.S.C. § 921(a). The filing must be properly authorized under local law, generally by resolution of the city council. Typically, the action is taken at an open meeting, but the deliberations surrounding the bankruptcy filing occur in a closed session.

City attorneys must ensure authorization is proper and should carefully safeguard the confidentiality and privilege of deliberations.

The city attorney may also take a central role in managing communications and maintaining confidentiality and privilege more generally, both before and during the bankruptcy. As a main point of contact between the city and its bankruptcy counsel, the city attorney will assist and advise as to what information should be made public, provided to the council, or kept among city management and advisors. In the San Bernardino bankruptcy, the city attorney was the city's spokesperson on legal matters, regularly drafting press releases and issuing statements to the press about the bankruptcy case.

Before the case begins, the city attorney may also have to address and seek outside counsel assistance on various matters of non-bankruptcy law, such as the securities disclosure and restricted fund issues mentioned above.

B. Effect of the Chapter 9 Petition

1. The Automatic Stay

Filing the petition immediately triggers the "automatic stay" of litigation and collection actions against the debtor and its property, even if a dispute over eligibility is pending. The automatic stay provides the debtor with breathing room to move toward a plan of adjustment. In chapter 9, the automatic stay also extends to actions against the debtor's officers and inhabitants that seek to enforce a claim against the debtor, such as mandamus actions. 11 U.S.C. § 922(a).

Under certain circumstances, creditors may ask the bankruptcy court for relief from the automatic stay to proceed with an action. For example, because San Bernardino faced a liquidity crisis at the beginning of its case, the city was unable to continue making certain payments to CalPERS. In response, CalPERS brought a motion for relief from the automatic stay seeking to pursue its state court remedies, which the bankruptcy court denied. In the end, the city and CalPERS reached an agreement that allowed the city to repay CalPERS over time.

2. Limited Authority of the Bankruptcy Court

The bankruptcy court's actual power over a chapter 9 debtor is circumscribed by the Tenth Amendment of the United States Constitution. Therefore, unlike in a typical chapter 11 business bankruptcy case, a chapter 9 debtor does not need to obtain bankruptcy court permission to make expenditures, enter into contracts, borrow money, sell assets, engage professionals, or engage in transactions out of the ordinary course of business. 11 U.S.C. §§ 903, 904. Likewise, a bankruptcy court cannot interfere with "(1) any of the political or government powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property." 11 U.S.C. § 904. As a consequence, the bankruptcy court's ability to order the debtor to take a particular action is limited. That limitation, together with the automatic stay, provides a chapter 9 debtor with significant flexibility in addressing short-term financial challenges. Also, unlike in a chapter 11 business bankruptcy case, the creditors cannot propose their own plan of adjustment, seek appointment of a trustee to control the debtor, or convert the case into a liquidation.

3. Appointment of Committees

The United States Trustee, the federal administrator charged with bankruptcy oversight, may appoint one or more official committees to represent creditors holding similar interests. In Vallejo, Stockton, and San Bernardino, the United States Trustee appointed an official committee of retirees. In other cases, such as Detroit and Puerto Rico, the United States Trustee also appointed an official committee of unsecured creditors. Once appointed, the official committees select counsel and financial advisors to provide advice and advocate on their behalf. In some cases, similarly situated creditors may also form unofficial, or ad hoc, committees to represent their common interests in the case.

While the Bankruptcy Code does not require a chapter 9 debtor to pay the professional fees of official committees, the debtor will often agree to do so within a negotiated budget. By organizing a constituency and serving as a point of contact for negotiations, official committees often prove useful in chapter 9 cases. And, while a committee cannot bind individuals to vote for a proposed plan of adjustment, the class represented by a committee will generally follow its recommendation.

4. Mediation with Stakeholders

Formal mediation among the city and its stakeholders will generally begin soon after the determination that the city meets the chapter 9 eligibility requirements, although in some cases the bankruptcy judge sends the parties to mediation even earlier. The city attorney will often attend or participate in these mediation sessions.

The goal of mediation will be to reach a consensual plan of adjustment, or at least to obtain the consent of as many stakeholders as possible. The mediation participants will likely be familiar faces from pre-bankruptcy negotiations, with the addition of any official committees appointed in the case. The mediators are often, though not always, present or former bankruptcy judges. The mediator in the Stockton case was Bankruptcy Judge Elizabeth Perris, the mediator in the San Bernardino case was Bankruptcy Judge Gregg W. Zive, and the mediator for Detroit was then-Chief Judge Gerald E. Rosen of the U.S. District Court for the Eastern District of Michigan.

Mediation has proven highly effective in bringing parties together to support chapter 9 plans. In *Stockton*, the city's plan of adjustment was confirmed over only one objection, a capital markets creditor. In *San Bernardino*, the city used mediation to reach agreements with its major creditor constituencies; only a group of litigation claimants maintained objections to the plan of adjustment, all of which were overruled by the bankruptcy court.

C. Treatment of Pensions, Benefits and Collective Bargaining Agreements

One of the most powerful tools available to a chapter 9 debtor is the ability to assume or reject executory contracts (a contract with material obligations remaining for both the debtor and a counterparty) and unexpired leases with the approval of the bankruptcy court. 11 U.S.C. § 365. Executory contracts are especially important in chapter 9 cases involving cities because they typically include collective bargaining agreements ("CBAs"). The Bankruptcy Code authorizes a chapter 9 debtor to reject contracts, including CBAs. 11 U.S.C. § 365(a). Contract rejection means that the debtor is no longer required to perform under the contract, and the creditor receives a general unsecured claim for the contract breach. 11 U.S.C. § 502(g).

Not all employee benefits will be owed under executory contracts; for some, the relevant contract may no longer be executory. For instance, health benefits owed to retirees are not executory contracts, because the retirees have already performed their side of the bargain. In such cases, the chapter 9 debtor may still reduce or eliminate the benefit, and the retiree will simply have a general unsecured claim against the debtor for amounts owing, as happened in the Stockton and San Bernardino chapter 9 cases.

1. Pension Benefits

While the Bankruptcy Code grants no special priority to pensions, the California Supreme Court has recognized a strict "vested right" in public employee pension benefits under the California Constitution (the so-called "California Rule"). Any modification of active employees' vested pension rights must, among other things, "be accompanied by comparable new advantages." *Marin Ass'n of Pub. Employees v. Marin Cty. Employees' Retirement Ass'n*, 2 Cal. App. 5th 674, 697 (2016) (citing *Allen v. Board of Administration*, 34 Cal. 3d 114, 120 (1983). And the pensions of retirees are to "receive an extra measure" of protection beyond that.[3] *Id.* at n.19.

In the Stockton case, CalPERS asserted that the California Rule prevented pension obligations from being modified under a plan of adjustment (though, in fact, Stockton was not seeking to impair pensions).[4] *In re City of Stockton*, 526 B.R. 35, 55-56 (Bankr. E.D. Cal. 2015). The bankruptcy court rejected CalPERS' argument, ruling that

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[3] Recent decisions of the California Courts of Appeal have called the inflexibility of the California Rule into question. *Alameda Cnty. Deputy Sheriff's Ass'n v. Alameda Cnty. Employees' Retirement Ass'n*, 19 Cal. App. 5th 61 (2018); *Marin*, 2 Cal. App. 5th 674. *Marin* allowed "reasonable" modifications to the pensions of active employees without a comparable new advantage. *Marin*, 2 Cal. App. 5th, at 697-700 (2016). The *Alameda* court disagreed with the holding of *Marin*. It would permit changes only if there were "compelling evidence" that the changes were necessary for continued operation of the pension system. *Alameda*, 19 Cal. App. 5th at 123. The issue is expected to come before the California Supreme Court shortly.

[4] Because Stockton did not attempt to impair pensions, CalPERS did not oppose the plan of adjustment. Rather, the bankruptcy court decided the issue because an objecting capital markets creditor argued that Stockton should be *required* to impair pensions. *Stockton*, 526 B.R. 35.

the Bankruptcy Code preempted a California statute (Cal. Gov't Code § 20487) that purported to limit the rejection of pension contracts. The bankruptcy court concluded that pensions contracts could be rejected and pensions may, as a matter of law, be modified by a chapter 9 plan of adjustment. 526 B.R. at 62. The court reasoned that pension rights are contract rights. And, while a state may decide whether or not its municipalities can file for bankruptcy, the debtor's ability to impair contracts under the Bankruptcy Code is available to states only on "an all-or-nothing, take-or-leave-it basis." *Id.* at 55. Thus, if a state allows its municipalities to file for bankruptcy, it cannot prevent those municipalities from impairing particular contracts. *See id.* at 57.

Had Stockton rejected or otherwise attempted to impair its contractual relationship with CalPERS, it could then be liable for the CalPERS termination charge under Cal. Gov't Code § 20577. CalPERS asserted that Stockton would owe $1.6 billion, but the bankruptcy court suggested that CalPERS would not have been able to enforce its statutory lien under Cal. Gov't Code § 20574 because certain liens can be avoided (made unenforceable) in bankruptcy cases. If that were the case, CalPERS' termination charge would have been only a general unsecured claim in the bankruptcy. The statutory lien issue was not actually litigated in the recent Stockton or San Bernardino cases, and no California bankruptcy court has yet addressed the enforceability of the lien.

The bankruptcy court in Detroit followed Stockton on bankruptcy impairment of pension obligations, holding that the city could impair pensions notwithstanding the Michigan State Constitution provided that pensions and retirement benefits were contractual obligations that could not be impaired. *In re City of Detroit*, 504 B.R. 191, 244 (Bankr. E.D. Mich. 2013).

Despite the Stockton bankruptcy court's ruling that pension contracts could be rejected and pensions could be modified, Stockton did not reject its agreement with CalPERS or attempt to modify pension benefits under its plan of adjustment. San Bernardino made a similar decision in its chapter 9 bankruptcy. Both faced the same fundamental issue: pensions are a crucial component of employee compensation, and there is no pension administrator in the marketplace comparable to CalPERS. Rejection of a CalPERS contract would have chilled negotiations with unions and retirees, and might even have precipitated a mass exodus of employees. However, the continuing rise in pension costs will no doubt lead cities to seriously consider attempting to impair pension obligations in future chapter 9 cases.

Both Stockton and San Bernardino were ultimately able to reach new CBAs and other agreements with unions and retirees that provided substantial pension savings for the cities. Stockton reached some of those agreements before bankruptcy, while San Bernardino first imposed the changes unilaterally in the first few months of its bankruptcy case, then moved for bankruptcy court approval of rejection of the CBAs, and finally reached consensual agreements with the retirees and new CBAs with the unions that were implemented under the chapter 9 plan. San Bernardino's new CBAs included a variety of provisions that reduced pension and benefit costs, including requiring employees to contribute the full statutory employee rates, eliminating the employer paid member contribution, removing pension-spiking provisions, reducing accruals and cash-outs of leave time, modifying retirement health benefits, and other related changes.

2. Other Post-Employment Benefits

Early in Stockton's bankruptcy, the city unilaterally suspended the payment of retiree health benefits. *Assoc. of Retired Employees v. City of Stockton (In re City of Stockton)*, 478 B.R. 8, 13 (Bankr. E.D. Cal. 2012). Retirees asked the court to order Stockton to continue making payments, arguing that their health benefits were vested rights. The bankruptcy court ruled in favor of Stockton, holding that the benefits were contract rights that could be unilaterally "modified or suspended" during the pendency of the case, notwithstanding California law. *Id.* at 23-24. The retirees would have a claim against the debtor for lost benefits, which would be dealt with in a plan of adjustment. *Id.* at 24-25. San Bernardino took a similar approach, using the Bankruptcy Code power to impair contract rights to reduce retiree health benefits.

3. Collective Bargaining Agreements

In chapter 9, a bankruptcy court will authorize the rejection a CBA under section 365 of the Bankruptcy Code if (a) the agreement burdens the debtor; (b) the equities balance in favor of rejecting the agreement; and (c) reasonable efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution. *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 104 S.Ct. 1188 (1984); *In re City of Vallejo*, 432 B.R. 262, 270 (E.D. Cal. 2010). The resultant union and employee damages claims will be treated as general unsecured claims. *In re City of San Bernardino*, 530 B.R. 489, 498 (C.D. Cal. 2015). Moreover, even before the debtor seeks to reject a CBA (or the court approves that decision), a debtor can *unilaterally* modify a CBA on an interim basis without violating the labor laws. *Retired Employees v. Stockton*, 478 B.R. at 23 (citing *Bildisco*, 465 U.S. at 527-34); *Vallejo*, 432 B.R. at 271.

The bankruptcy power to unilaterally modify employee wages and benefits, then actually reject a CBA, allows municipalities to impose changes to the terms of employment without following the procedures required under state labor law. *San Bernardino*, 530 B.R. at 497; *Vallejo*, 432 B.R. at 270. Under California labor law, the cities and unions must generally negotiate to impasse before any modifications to terms and conditions of employment can be made, a period that can last many months or even years—time that a city with a cash flow crisis cannot wait for. San Bernardino, for example, was quickly running out of cash at the beginning of its bankruptcy case, and bankruptcy allowed it to unilaterally impose interim changes to certain CBAs and immediately reduce the cost of operating the city. When the bankruptcy court granted the city's motion to reject the CBAs, the city made the imposed changes permanent. *San Bernardino City Prof'l Firefighters Local 891 v. City of San Bernardino (In re City of San Bernardino)*, 530 B.R. 474, 489 (C.D. Cal. 2015).

In addition to using bankruptcy to make necessary modifications to its CBAs, San Bernardino also determined to contract out the provision of fire services. The city's firefighters union opposed those efforts, arguing that state law and the city's charter prohibited the city from contracting out. However, the bankruptcy court ruled that San Bernardino could contract out fire services, and the decision was upheld on appeal. *San Bernardino City Prof'l Firefighters Local 891 v. City of San Bernardino (In re City of San Bernardino)*, No. 5:15-cv-01562-ODW, 2015 U.S. Dist. LEXIS 170882 (C.D. Cal. Dec. 22, 2015). Ultimately, after winning on the issue of contracting out, the city obtained approval from the local agency formation commission to annex into the county firefighting agency, and the city reached a financial settlement with the firefighters union as part of the city's chapter 9 plan.

Chapter 9 debtors often find it advantageous to have the bankruptcy court adjudicate such issues. The bankruptcy court will have a deep knowledge of how a particular dispute fits into the overall context of the bankruptcy, and litigation in bankruptcy courts often proceeds over an expedited timeframe. The city attorney plays a key role in coordinating the purely bankruptcy legal battles with other state-law related issues like contracting out and local agency formation commission negotiation and compliance.

D. Bond Debt

Special revenue bonds are bonds secured by "special revenues," which include receipts from providing transportation and utility services, and taxes specifically levied to finance a project or system (*e.g.*, ad valorem property taxes used to build sewage systems and schools). 11 U.S.C. § 902(2). Special revenue bonds are the most common type of secured debt of a municipality.

Special revenue bondholders are given enhanced protections under the Bankruptcy Code. The liens of special revenue bondholders extend to special revenues acquired after commencement of the case, and they may demand interest and principal payments during the bankruptcy case. 11 U.S.C. §§ 922(d), 928(a). There are, however, limitations on the rights of special revenue bondholders. The revenues may be used to pay the operating expenses of the underlying project, 11 U.S.C. § 928(b), and if there are not enough special revenues to pay the special revenue bond obligations in full, the bondholders are not entitled to a claim for the deficiency. 11 U.S.C. § 927.

General obligation bonds issued by cities, in contrast, are not secured by a particular stream of income or assets and are typically treated differently than bonds secured by "special revenues." General obligation bonds can often be classified as general unsecured debt in chapter 9 and heavily impaired.

In the San Bernardino case, the city sought to treat pension obligation bondholders as unsecured creditors under its chapter 9 plan of adjustment. The pension obligation bondholders argued that their bonds were entitled to the same priority of payment as CalPERS (*i.e.*, paid in full instead of being treated as general unsecured claims). The bankruptcy court ruled in favor of the city, the bondholders appealed, and a settlement was achieved in mediation that substantially discounted the bondholder claims.

In 2015, California enacted Senate Bill 222, which provides a statutory lien for certain general obligation bonds. The scope and impact of SB 222 has not been addressed by any state or federal court.

E. Litigation Claimants

Litigation claims against a municipality for damages are also treated as general unsecured claims under the Bankruptcy Code, and they can therefore be subject to significant impairment. However, many litigants assert claims not just against a municipality but also against employees acting in the ordinary course of their employment. Under California law, the municipality is obligated to fully indemnify the employees, but a typical plan of adjustment only modifies claims against the municipality itself. As a consequence, a municipality would have to pay judgments against employees in full, even though similar claims against the municipality might receive only pennies on the dollar. This issue is particularly significant in light of increasing verdicts against police officers for actions within the scope of employment.

San Bernardino addressed this problem by requesting and obtaining a plan injunction that was the first of its kind issued in connection with a chapter 9 plan of adjustment. *In re City of San Bernardino*, 566 B.R. 46 (Bankr. C.D. Cal. 2017). The injunction enjoined litigants from collecting judgments against individual employees, instead providing them with a general unsecured claim and the ability to collect from any available insurance. The bankruptcy court granted the injunction, supported by detailed findings that the injunction was necessary to the success of San Bernardino's plan of adjustment and subsequent financial recovery. The court found that without the plan injunction, the city could not afford to maintain public safety or provide essential services to its citizens. San Bernardino's plan, including the injunction, has since been fully implemented, and no appeals are pending.

While the injunction was grounded in San Bernardino's unique circumstances, and such injunctions outside chapter 9 are generally disfavored in the Ninth Circuit, the San Bernardino precedent may well be of great interest to municipalities in financial distress where the city's debt burden includes judgments and pending claims against the city's police officers or other employees.

F. Exiting Bankruptcy: Confirmation of a Plan of Adjustment

The ultimate goal of a chapter 9 case is for the debtor to emerge with a successful plan of adjustment that restructures its debt and obligations to a sustainable level. The plan of adjustment is a formal document that provides for the treatment of the various classes of claims against the municipality, as well as for the means of implementation. 11 U.S.C. § 1123. For San Bernardino, the means of implementation included, among other things, operational improvements, the outsourcing of fire and waste management services, city charter reform, new revenues, and various cost-reduction measures to generate substantial savings.

1. Summary of Plan Process

A municipal debtor must submit the plan of adjustment, along with an explanatory disclosure statement, to the holders of claims and the bankruptcy court for approval and confirmation. 11 U.S.C. § 1125. Only the municipal debtor may be a plan proponent in a chapter 9 case. 11 U.S.C. § 941. This gives the debtor a significant measure of strategic control, as there can be no creditor-sponsored competing plans.

The creditors may vote on and raise objections to the plan (though successful mediation may render most creditor votes a foregone conclusion). The court then holds a confirmation hearing to consider the plan, objections, and votes. 11 U.S.C. § 1128. If the court decides the plan meets the requirements of the Bankruptcy Code, then the court confirms the plan, and it becomes binding upon the debtor and creditors. 11 U.S.C. § 1129. The key confirmation requirements are summarized below.

2. Confirmation Requirements

The plan must be in the best interest of creditors. 11 U.S.C. § 943(b)(7). To meet this requirement, a debtor need only show that its plan of adjustment is "better than any of the alternatives." *Sanitary & Improvement District No. 7*, 98 B.R. 970 (Bankr. D. Neb. 1989); *Franklin High Yield Tax-Free Income Fund v. City of Stockton (In re City of Stockton)*, 542 B.R. 261, 285 (B.A.P. 9th Cir. 2015). And, since confirmation and dismissal are the only two possible outcomes in a chapter 9 case, this is often not a difficult test to meet. Dismissal is usually not an attractive option for the creditors.

The plan must also be feasible, meaning there is a reasonable prospect that the debtor will be able to perform under the plan. 11 U.S.C. § 943(b)(7). The court will usually make this determination by reviewing the reasonableness of the projections provided by the debtor. Experts and consultants usually assist in the preparation and presentation of these projections.

A plan will be confirmed if it meets the requirements above and each impaired class of creditors votes to accept it. 11 U.S.C. § 1129(a)(8). Impairment essentially means that the rights of the creditor are altered in some way. 11 U.S.C. § 1124. A class of creditors accepts a chapter 9 plan if more than two-thirds in dollar amount and majority in the number of creditors voting in that class vote to accept the plan. 11 U.S.C. § 1126(c). The San Bernardino chapter 9 plan was accepted by all classes of voting creditors.

3. Cram Down of Dissenting Classes

If a municipal debtor's plan meets all of the other requirements of confirmation, but a class of creditors fails to accept the plan, the court may nevertheless approve the plan over the objection of the dissenting class of creditors and "cram down" the plan on that dissenting class of creditors, but only if (i) the plan is "fair and equitable," (ii) the plan "does not discriminate unfairly," and (iii) at least one class of impaired claims voted in favor of the plan. 11 U.S.C. §§ 1129(a)(10), 1129(b).

A debtor's ability to impair secured claims by cram down is limited, because secured creditors have constitutionally protected property rights. That said, in appropriate cases a debtor can often achieve interest rate reductions, lengthened payment periods, and alteration of terms. Also, because special revenue liens are typically non-recourse, *see* 11 U.S.C. § 927, the debtor may be able to cram down a reduction in principal if the present value of the payment stream is less than the value of the bonds.

For unsecured creditors, a plan is considered "fair and equitable" if the amount to be received by the dissenting class is "all they can reasonably expect to receive under the circumstances." *Lorber v. Vista Irrigation Dist.*, 127 F.2d 628, 639 (9th Cir. 1942). Thus, general unsecured claims can be often be impaired significantly. The appropriate payout will be based on what the court believes the debtor can afford to pay and, under that standard, the municipality does not have to discontinue its services. The municipality must be permitted to continue to operate as a viable entity and provide basic services; it may have to scale down, but it only has to pay its creditors what a court finds to be reasonable—and that may sometimes be a fairly low hurdle to meet. San Bernardino's confirmed plan paid one cent on the dollar to general unsecured claims, and it saved hundreds of millions of dollars through the reduction of claims and operating expenses.

IV. Chapter 9: Advantages and Disadvantages

Distressed cities should carefully consider the advantages and disadvantages of a potential chapter 9 filing. This section provides a brief summary of each.

A. The Advantages of Chapter 9

Relief from Creditor Action: Breathing Room. The most immediate protection conferred by chapter 9 is relief from creditor action. The filing of a chapter 9 bankruptcy invokes an automatic stay of any lawsuits or other collection action against a municipality and certain other parties. A municipality will therefore have breathing space while it attempts to resolve cash flow problems and formulate a plan of adjustment. If the entity is facing a lawsuit or other imminent action such as judgment enforcement, the automatic stay can be a very significant advantage for a municipal debtor.

Adjustment of Debt. The bankruptcy court in a chapter 9 case can compel a recalcitrant creditor or class of creditors to accept a plan over their objections, under the cram down powers of the bankruptcy court. The power of a chapter 9 filing to force a plan on the creditors that reduces their claims, perhaps substantially to "tiny bankruptcy dollars," can result in large savings for the municipality.

Rejection of Burdensome Contracts. A municipal debtor has the ability to reject burdensome executory contracts, including collective bargaining agreements.

Consolidate Disputes in Single Forum before Restructuring Expert. The municipality can consolidate all disputes before one forum as opposed to multiple courts, and centralize the resolution of these disputes. This may be particularly important if the case involves a number of complex issues. The bankruptcy judge has expertise in debtor/creditor and inter-creditor disputes and will be familiar with the municipality's debt structure and operations. Bankruptcy litigation also generally proceeds much faster than litigation before other state and federal courts.

Few Operational Impediments. A municipality can continue its day-to-day operations, without interference by the bankruptcy court or other parties. The bankruptcy court may not interfere with the municipality's political or governmental powers, property or revenues.

B. The Disadvantages of Chapter 9

Expense. There are significant ongoing costs associated with retaining legal and financial professionals to assist with administration of the case, negotiating with creditors, and developing a plan of adjustment, and professional fees are generally paid monthly. Nevertheless, the short-term savings made available under the bankruptcy powers generally exceed the costs of the bankruptcy, and the long-term savings from confirming a chapter 9 plan of adjustment can run into the hundreds of millions of dollars.

Attention of Staff. A filing will distract elected officials and government personnel who must field questions about the filing and assist in the administration of the case. Staff must devote time to management and administration of the case, dealing with court filings, outside professionals, creditors, and disclosure requirements.

Reaction of Credit Markets and Vendors. When a municipality files chapter 9, its credit rating will go down and be watched more carefully in the future. Even discussion of bankruptcy can affect markets. Creditors will be reluctant to extend credit, at least at the beginning of the case, and this may cause further tightening to an already strapped municipal budget. Yet a chapter 9 can also be a vehicle to return a municipality to financial health and allow it to re-enter the credit markets. Several large municipalities have restructured successfully and had their access to the capital markets restored.

V. Conclusion and Key Takeaways

Chapter 9 bankruptcy often represents a distressed city's last resort. Indeed, even the Bankruptcy Code requires municipalities to make a good faith effort to avoid bankruptcy before they can be eligible to file for chapter 9. Nonetheless, in the coming years, some California cities will find themselves facing down a bankruptcy. Even for those cities who never file, the looming threat of chapter 9 may help spur the tough decisions and painful compromises necessary to avoid bankruptcy.

With that in mind, city attorneys will benefit from having a working knowledge of some the chapter 9 issues discussed in this paper. In particular, city attorneys thinking about chapter 9 should take away the following key points from this paper:

- Cities should fully understand the nature of their financial problems and take whatever steps possible to address them, as early as is practicable. City attorneys should also be alert to issues surrounding the use of restricted funds.

- At an early juncture, a troubled city should hire experienced bankruptcy counsel and financial consultants, a process that will likely involve the city attorney. Experienced professionals can help identify financial problems and find solutions. Also, bankruptcy law will likely impact a city's negotiations with stakeholders to avoid bankruptcy.

- If a city does decide to file, it will have to meet the eligibility requirements for a filing, namely that the city is insolvent and has engaged in good faith negotiations with creditors to the extent practicable. It may require substantial advance preparation to meet these requirements and to prove them to the bankruptcy court.

- The city attorney will be closely involved in the chapter 9 case, both before and during proceedings. That involvement may include managing communications and the press, ensuring the city remains in compliance with applicable non-bankruptcy law, and appearing and assisting at hearings throughout the case.

- The Bankruptcy Code allows chapter 9 debtors to reject CBAs and impair pension obligations and post-employment benefits, upon appropriate showings.

- Mediation, in which the city attorney will participate, is an important part of the chapter 9 case. Several chapter 9 debtors have used mediation to achieve near-complete consensus on a plan of adjustment.

- A city exits bankruptcy by confirming a plan of adjustment, which modifies its debts and may generate significant savings. If a city cannot obtain the agreement of certain classes of creditors, it may be able to "cram down" those modifications.