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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re: CITY OF STOCKTON, CALIFORNIA, Debtor.	**Case No. 12-32118** **D.C. No. OHS-1** **Chapter 9** **NATIONAL PUBLIC FINANCE GUARANTEE CORPORATION'S OBJECTION TO THE CITY OF STOCKTON'S QUALIFICATIONS UNDER SECTION 109(C)** Date: August 23, 2012 (Status Conference) Time: 10:00 a.m. Dept: Courtroom 35 Judge: Hon. Christopher M. Klein

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

National Public Finance Guarantee Corporation ("National"), a creditor and party in interest,[1] hereby objects, pursuant to sections 109(c)(5) and 921(c) of the Bankruptcy Code, to the City of Stockton, California's (the "Debtor," or the "City") eligibility for relief under chapter 9 of the Bankruptcy Code. In support of this objection, National states as follows:[2]

I. Background

A. National

1. National insures (1) those certain Lease Revenue Bonds, Series 2004 (Parking and Capital Projects) issued by the Stockton Public Financing Authority (the "Authority") in the aggregate principal amount of $32,785,000 (the "Parking and Capital Projects Bonds") pursuant to that certain Indenture of Trust dated as of June 1, 2004 by and between the Authority and Wells Fargo Bank, National Association, as Trustee (the "2004 Parking and Capital Projects Indenture"); (2) those certain Lease Revenue Refunding Bonds, 2006 Series A issued by the Authority in the aggregate principal amount of $13,965,000 (the "Building/Parking Facility Bonds") pursuant to that certain Indenture of Trust, dated as of March 1, 2006, by and between the Authority and Wells Fargo Bank, National Association, as Trustee (the "2006 Building/Parking Facility Indenture"); and (3) those certain Revenue Bonds, Series 2004 (Stockton Events Center-Arena Project) in the aggregate amount of $47,000,000 (the "Events Center Bonds," and collectively with the Parking and Capital Projects Bonds and the Building/Parking Facility Bonds, the "Lease Finance Bonds"), issued by the Redevelopment Agency of the City of Stockton (the "Agency") pursuant to that certain Indenture of Trust, dated as of March 1, 2004, by and between the Agency and Wells Fargo Bank, National Association, as Trustee (the "2004 Events Center Indenture," and collectively with the 2004 Parking and Capital Projects Indenture and the 2006 Building/Parking Facility Indenture, the "Stockton Lease Indentures").[3]

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[1] *See* National's Joinder of Creditor National Public Finance Guarantee Corporation to Indenture Trustee's Limited Objection to the Debtor's Emergency Motion for Leave to Introduce Evidence Relating to Neutral Evaluation Process under Government Code Section 53760.3(Q) [Docket No. 78] (the "Joinder") establishing that National is a secured creditor and party in interest of the City of Stockton, California.

[2] To date the City has failed to respond in any meaningful way to National's request for voluntary consensual discovery. National reserves the right to supplement this Objection with additional legal and evidentiary bases following the conclusion of discovery.

[3] National also insures certain additional debt related to the City, which is set forth in the Joinder.

2. In connection with the Lease Finance Bonds, the respective issuers entered into leases with the City, as lessee (the "City Leases"), whereby the City is obligated to make payments to the issuer of the bonds to fund payment of the bonds under the Stockton Lease Indentures. Under the respective City Leases and Stockton Lease Indentures all rights of each issuer were assigned to the Trustee.

3. Events of default have occurred under the City Leases and the Stockton Lease Indentures in several respects. For example, prior to the commencement of the City's chapter 9 case, an event of default occurred and is continuing under the 2004 Parking and Capital Projects Indenture triggered by the City's failure to make the required lease payments under the City Lease.[4] In addition, events of default have occurred on all other Stockton Lease Indentures as a result of the City's filing of its chapter 9 case.

4. To the extent the City does not satisfy its obligations under any of the debt issuances insured by National, National will be responsible to bondholders for the full principal and interest payments when due as required by the insurance policies guaranteeing such payment.

B. Procedural History

5. On March 27, 2012, the City commenced a "neutral evaluation process" pursuant to Assembly Bill ("AB 506"), which is codified at California Government Code 53760 *et seq*.

6. The City invited many of its creditors and parties in interest to participate in the AB 506 process. *See* Decl. of Marc A. Levinson in Support of City of Stockton's Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Docket No. 452] (the "Levinson Decl.") Ex. A (Attaching City of Stockton's Mar. 21, 2012 Press Release). The press release provides that National, as well as the City's employee unions, California Public Employees' Retirement System ("CalPERS"), the trustee for the bonds, bondholders and other bond insurers were invited to participate in the AB 506 process. *See id.*

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[4] On March 1, 2012, the trustee notified the City of certain Events of Default including an Event of Default under Section 9.1 of the Parking Lease due to the City's failure to make the lease payment due on February 25, 2012, and an Event of Default under Section 7.01 (d) of the 2004 Parking and Capital Projects Indenture which provides that the occurrence of an event of default under the Parking Lease is an Event of Default under the 2004 Parking and Capital Projects Indenture.

C. The City's "Ask"

7. On May 7, 2012, the City submitted its 790 page Proposals for Modifications to Obligations Under AB 506 Process (the "Ask") to the AB 506 participants. *See* Decl. of David N. Millican in Support of City of Stockton's Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Docket No. 454], Ex. A (Attaching the Ask).

8. The Ask purports to describe the City's proposals to realize "savings" from existing obligations. Ask at 5. The proposals in the Ask are broken down into four categories "(1) labor, (2) retiree medical for current retirees and current employees, (3) debt and (4) other contracts and claimants." *Id.*

9. The total annual impact on the City's budget from "savings" proposed in the Ask ranges from $25 million in 2012-13 to $33 million in 2020-21. *Id.* at 67.

10. Labor concessions proposed in the Ask are comprised mainly of the elimination of add pays, separation pay and longevity pay, reducing city-paid life insurance and changing overtime calculations. *Id.* at 24-36. The City projects annualized savings to the General Fund from this proposal in 2012-13 of $4.8 million. *Id.* at 57.

11. Retiree concessions proposed in the Ask are primarily related to the gradual elimination of all health benefits currently paid by the City, to be phased in over the next few years. *Id.* at 37-41. The City projects annualized savings to the General Fund from this proposal in 2012-13 of $7 million. *Id.* at 57.

12. Debt concessions proposed include the elimination of all obligations of the General Fund to pay any existing debt of the City, the restructuring of existing bonds into 40-year instruments, a five year holiday for any debt payments, interest only payments for the next five years, the exhaustion of existing debt reserve accounts or suretys and revised amortization on a 30 year schedule beginning in 2022-23. The new interest rate on the restructured obligations is proposed to be reduced to 2.5%. The Ask also seeks to reduce the principal and interest payments on the City's 2007 Pension Obligation Bonds by an astonishing 83%. *Id.* at 42-48. The City projects annualized savings to the General Fund from these proposals in 2012-13 of $10.5 million. *Id.* at 57.

13. The City also seeks concessions from miscellaneous other "contracts and claimants," *id.* at 49-56, with projected annualized savings to the General Fund in 2012-13 of $2.6 million. *Id.* at 57.

14. The City's obligation under its contracts with CalPERS, which are projected at $17 million in 2012-13 and increasing to over $30 million annually by 2020 are unaffected in the City's proposal. *Id.* at 65.

15. The City states in its Eligibility Memorandum (as defined below) that its intent in developing the Ask was to "restructure its obligations in a way to achieve solvency while treating creditors equitably." *See* Eligibility Memorandum at 39. However, the Ask makes clear that even if all proposed concessions are achieved, the City forecasts an annual deficit starting in 2013-14 of over $5 million, growing to over $17 million annually by 2020-21, with a total deficit over the projection period of nearly $100 million. Ask at 58. Further, the Ask is disproportionately dependent on concessions under the City's debt obligations. While 2012-2013 debt service savings of $11.3 million represents 44% of $25.8 million in total concessions sought by the Ask, 2012-13 debt service expenses of $13.6 million represents only 7.5% of the City's baseline expenditures, which are projected to be $180.7 million for 2012-2013. *See* chart attached to National's Exhibit Index filed herewith as Exhibit A. This disproportionate treatment is not limited to 2012-13, as each year of the City's forecast shows outsize concessions from the City's debt obligations relative to City expenditures.

D. The AB 506 Mediation

16. The City held AB 506 mediation sessions on 32 different days during the AB 506 process. *See* Levinson Decl., Ex. B. CalPERS participated in the initial meetings on April 30, 2012 and May 1, 2012 and one additional meeting on June 8 "to discuss retirement benefits" with the City's police unions. *See id.*

17. The City was unable to resolve its disputes with the AB 506 participants and the AB 506 process concluded on June 25, 2012, after the initial 60 day statutory period set for the process was extended by an additional 30 days.

18. On June 28, 2012, the City commenced this case by filing a petition under chapter 9 of the Bankruptcy Code. For support, the City filed a Statement of Qualifications Under Section 109(c) [Docket No. 5] (the "Eligibility Statement") and a Memorandum of Fact and Law in Support of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Docket No. 19] (the "Eligibility Memorandum") and associated declarations and exhibits (together with the Eligibility Statement and the Eligibility Memorandum, the "Eligibility Pleadings"). The City also filed its schedule of 20 largest unsecured creditors. *See* Docket No. 4. The City lists CalPERS as its single largest unsecured creditor with an estimated claim of $147,500,000.00, dwarfing all other unsecured claims. *See id.*

E. The City's Liability to CalPERS and Its Effect on City Finances

19. The City admits that its liability to CalPERS has greatly contributed to the City's cash and budget crisis. One of the City's Deputy Managers, Laurie Montes, states in her declaration in support of the Eligibility Statement that:

> Another deficit was projected, with the main drivers being . . . increases in pension contribution rates required by CalPERS . . .

Decl. of Laurie Montes in Support of City of Stockton's Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Docket No. 23] (the "Montes Decl.") at ¶ 23 (quoting Feb. 15, 2011 staff report).

1. Description of CalPERS and Its Management

20. CalPERS is an agency of the California executive branch that manages retirement benefits for more than 1.6 million California public employees, retirees, and their families. CalPERS was established by state law in 1931 to provide retirement benefits for state employees. In 1939, public agency and classified school employees were allowed to participate in CalPERS.

21. CalPERS manages a total of $233 billion in assets, spread amongst different sub-funds for each employer or municipality or employee group. Over the past twenty years, CalPERS' fiscal year performance has been volatile, due to both market valuations and asset allocation decisions with annualized returns ranging from 25.3% to as low as -27.8%. *See* CalPERS, *Facts at a*

Glance (July 2012), a true and correct copy of which is attached to National's Exhibit Index filed herewith as Exhibit B.

22. CalPERS membership is divided among current and retired employees of the state, schools, and participating public agencies. CalPERS operates a defined benefit retirement plan for members through its Board of Administration (the "board") that provides benefits based on a member's years of service, age, and compensation (*i.e.*, a certain formula fixes the sum a pensioner is to recover upon retirement).

23. To manage the retirement fund, the board, which consists of 13 members, 6 of whom are member elected, 3 of whom are Governor/legislature appointed and 4 statutory members (State Treasurer, State Controller, Director of Department of Personal Administration, and member designated by the State Personnel Board), has broad and exclusive control over the administration and investment of the retirement system's funds.

24. The Public Employees' Retirement Law ("PERL") provides that the CalPERS fund "is a trust fund created, and administered…solely for the benefit of the members and retired members of this system and their survivors and beneficiaries." Cal. Gov. Code § 20170. Under Cal Gov. Code § 20171 "[t]he board has the exclusive control of the administration and investment of the retirement fund."

25. Further, the "board shall have all powers reasonably necessary to carry out the authority and responsibilities expressly granted or imposed upon it under this [law]." Cal. Gov. Code § 22794. Among its authorities, the board has the power to enter into contracts. *See e.g.* Cal. Code § 21663 and Cal. Gov. Code § 20573.

26. CalPERS' rights and obligations are defined both by the PERL and by contract. "Any public agency [such as the City] may participate in and make all or part of its employees member of this system by contract entered into between its governing body and the board…" Cal. Gov. Code § 20460 (emphasis added). Membership in the retirement system is compulsory for all employees included under a contract.[5] Cal. Gov. Code § 20502; *see also* Cal. Gov. Code § 20281

[5] Certain persons are, however, excluded from the system. *See e.g.* Cal. Gov. Code § 20303(a) ("[p]persons who are members of any other retirement or pension system supported wholly or in part by funds of the United States

(stating that "[a]n employee of a contracting agency on the effective date of its contract with the board becomes a member immediately. Every other employee becomes a member upon his or her entry into employment").

2. Rights and Obligations of CalPERS

27. The City's obligation to CalPERS arises under its contracts with CalPERS which have been in effect in various forms since 1944. *See* Contract between the City Council and CalPERS dated September 1, 1944 and amendments thereto dated July 1, 1948 and March 16, 2002, true and correct copies of which are attached to National's Exhibit Index filed herewith as Exhibit C. Thus, employees of the City are members of CalPERS and entitled to receive benefits from CalPERS as set forth in the PERL. For its part, the City is obligated to contribute amounts to CalPERS to fund such benefits while its contract with CalPERS remains in effect.

28. Cal Gov. Code §20572 permits the board to terminate its contracts with the City if the City fails, for 30 days after demand by the board, to pay any installment of contributions required by its contract.

29. Cal Gov. Code § 20577 provides, in part:

> If, at the date of termination, the sum of the accumulated contributions credited to, or held as having been made by, the contracting agency[6]…is less than the actuarial equivalent…the agency shall contribute to this system under terms fixed by the board…If the agency fails to pay to the board the amount of the difference, all benefits under the contract, payable after the board declares the agency in default therefore, shall be reduced…
>
> **The right of an employee of a contracting agency, or his or her beneficiary, to a benefit under this system, whether before or after retirement or death, is subject to the reduction.**

(emphasis added).

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government, any state government, or any political subdivision thereof and who are receiving credit in the other system for service are, as to that service, excluded from this system").

[6] A "contracting agency" is "any public agency that has elected to have all or any part of its employees become members of the CalPERS system that has contracted with the board for that purpose." Cal. Gov. Code § 20022. Thus, the City is a "contracting agency" with CalPERS.

30. Importantly, if a contract has been terminated pursuant to Cal Gov. Code §20572 (as discussed above), the board will merge the terminated agency's plan assets and liabilities into a single pooled account to provide for payment of benefits to all members of terminated plans. *See* Cal. Gov Code § 20576(b).

31. Funds from all terminated agency plans are paid from this one terminated agency pool. New contributions are not made into this pool, but instead the pool is funded by investment earnings. *See* Press Release, "CalPERS Acts to Ensure Benefits of Terminated Agency Members" (Aug. 17, 2011), a true and complete copy of which is attached to National's Exhibit Index filed herewith as Exhibit D. Thus, the board may transfer the terminated agency's plan assets and liabilities into the terminated agency pool without (or with partial) reduction to member benefits as determined by the board. Funds from the pool are then used to pay benefits when workers from the terminating agencies retire.

3. Financial Impact of CalPERS Liability on the City and the City's Failure to Ask for any Reduction Thereof

32. Evidence of the effect that the City's increasing CalPERS liability has had on the City's finances is described in the February 2012 financial assessment report prepared by Management Partners at the City's request. *See* Ex. P to Decl. of Laurie Montes in Support of City of Stockton's Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Docket. No. 25] ("Ex. P to Montes Decl."). The report describes the financial problems the City faces due to its current and projected CalPERS liability:

- Section 5 of the Key Observations states that:

> Management Partners believes that these additional risks listed below…may create immediate cash insolvency in the General Fund.
>
> . . .
>
> f. The City could see higher California Public Employees Retirement System (CalPERS) rates than currently forecast after FY 2012-2013.

> . . .
>
> h. The City has unfunded actuarial liabilities…in both its CalPERS pension plans and its Enhancement Plan."

Id. at 7.

- "Issuance of pension obligation bonds just before the FY 2008-09 financial crisis resulted in a loss of almost a third of the debt proceeds that were deposited in the CalPERS investment portfolio over the following two years. This erased expected cash savings in CalPERS rates and requires the City to pay debt service on the $125 million issue amount while only getting the benefit of $82.5 million in the CalPERS portfolio." *Id.* at 17.
- "A major contributing factor to the City's cash and budget crisis on the expenditure side is that its costs of amortizing CalPERS unfunded liabilities has increased by $6.2 million per year to $10.8 million per year between FY 2010-11 and FY 2012-13 (a 290% increase) according to CalPERS' most recent analysis." *Id.* at 41.

33. As detailed above, the 790 page Ask that the City proposed sets forth substantial reductions in the City's obligations to its creditors, however, noticeably absent from the Ask are any proposed reductions in the City's CalPERS liability, which is estimated to total $245 million over the City's ten year projection period. *See* Ask at 65.

34. Despite the fact that the PERL permits CalPERS to terminate the City's contracts and transfer its plan assets and liabilities to the terminated agency pool (as discussed above), the City never asked for a single dollar in reduction of its liability to CalPERS. The City does not even list CalPERS in its Outcome of AB 506 Mediation Sessions. *See* Levinson Decl., Ex. C. Moreover, the City explicitly states in the Ask that it is going to attempt to "preserve pension funding for current retirees and current employees who will retire under the CalPERS system." *See* Ask at 38. Such employees include the Mayor, City Council and other City employees -- the very people that developed the Ask, and have been receiving allegedly improper CalPERS benefits for years. *See* Michael Fitzgerald "*City has been Paying Illegal Benefits for Years*," Recordnet.com, Apr. 25, 2012, a true and correct copy of which is attached to National's Exhibit Index filed herewith as Exhibit E.

35. Further, in Section 12.8(e) of the proposed Memorandum of Understanding with Stockton City Employees Association ("SCEA") the City promised the SCEA it would not reduce its CalPERS liability:

> **No Adverse Affect on CalPERS.** The City represents and warrants based on information provided by the California Public Employees Retirement

> System (CalPERS) that the furlough deductions described in this Article 12.8 shall not reduce or otherwise adversely affect the employee's Final Compensation for retirement purposes under the CalPERS. . . . As an express condition of this Section, should any SCEA represented employee suffer a reduction or adverse affect in his or her Final Compensation for retirement purposes through CalPERS solely as a result of the furlough deductions, the City, upon notification, shall thoroughly review and communicate the adverse affect to CalPERS, on behalf of the employee, to ensure the employee is made whole.

Ask at 133.

36. The proposed Memorandum of Understanding with the Trades and Maintenance Unit includes a similar provision. *Id.* at 282-283.

II. Argument

A. The City Has Not Negotiated in Good Faith with its Creditors

37. The City has failed to carry its burden of showing that it meets the eligibility requirements under section 109(c) as it did not negotiate in good faith with its creditors as required by section 109(c)(5)(B) of the Bankruptcy Code because (i) the City did not intend to and in fact did not negotiate with its single largest unsecured creditor, CalPERS, either before, during or after the AB 506 process, which negotiations were not impracticable; and (ii) the Ask is not a feasible plan or in the best interests of creditors.

38. In order for a municipality to be eligible to file for relief under chapter 9 of the Bankruptcy Code, it must meet the requirements in section 109(c) of the Bankruptcy Code. In particular, a municipality must prove that it has negotiated with its creditors in good faith. *See* 11 U.S.C. § 109(c)(5)(B).

39. Section 109(c)(5)(B) provides, in pertinent part:

> (c) An entity may be a debtor under chapter 9 of this title if and only if such entity—
>
> (5)
> . . .
> (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;

11 U.S.C. § 109(c)(5)(B).

40. Chapter 9 petitions should be viewed "with a jaded eye." *In re N.Y.C. Off-Track Betting Corp.*, 427 B.R. 256, 264 (Bankr. S.D.N.Y. 2010). "Principles of dual sovereignty, deeply embedded in the fabric of this nation and commemorated in the Tenth Amendment of the United States Constitution, severely curtail the power of bankruptcy courts to compel municipalities to act once a petition is approved." *Id.*; *see also In re Sullivan County Reg'l Refuse Disposal Dist.*, 165 B.R. 60, 82 (Bankr. D.N.H. 1994) ("Considering the bankruptcy court's severely limited control over the debtor once the petition is approved, access to Chapter 9 relief has been designed to be an intentionally difficult task").

41. "The burden of establishing eligibility under § 109(c) is on the debtor." *In re Valley Health Sys.,* 383 B.R. 156, 161 (Bankr. C.D. Cal. 2008); *see also Int'l Ass'n of Firefighters, Local 1186 v. City of Vallejo (In re City of Vallejo)*, 408 B.R. 280, 289 (9th Cir. BAP 2009).

42. Section 921(c) of the Bankruptcy Code requires a court to dismiss a chapter 9 petition if the debtor fails to satisfy the requirements under section 109(c). *See id.* (observing that courts require dismissal of chapter 9 petitions filed by debtors "who fail[] to meet the eligibility requirements under § 109(c)"); *In re Valley Health Sys.*, 383 B.R. at 160 (same).

1. <u>The City Did Not Negotiate at All with CalPERS, its Largest Unsecured Creditor</u>

43. The City has not presented a <u>*prima facie*</u> case that its negotiations prior to filing the petition and during the AB 506 process were in good faith and meet the statutory requirements of section 109(c)(5)(B). In order to prove that its negotiations were in good faith, the debtor must prove that it brought into the negotiations <u>all</u> assets and liabilities while negotiating with creditors. *See Sullivan County*, 165 B.R. at 78 ("A commercial party can hardly 'negotiate in good faith' regarding unpaid obligations if it chooses to ignore clear, unambiguous contractual rights of the other party and, more importantly, refuses to acknowledge or throw into the negotiating equations a large and significant asset that it holds.")

44. Further, in order to satisfy section 109(c)(5)(B), a debtor must actually engage in meaningful negotiations with its creditors. *See In re Ellicott Sch. Bldg. Auth.*, 150 B.R. 261, 266 (Bankr. D. Colo. 1992) ("take-it-or-leave-it proposal" in which "the substantive terms of a proposal

were not open to discussion" does not constitute good-faith negotiations); *see also City of Vallejo*, 408 B.R. at 297 (finding that the City of Vallejo did not satisfy section 109(c)(5)(B) because it "never negotiated with Unions or any of its creditors over the possible terms of a plan of adjustment"); *In re Cottonwood Water and Sanitation Dist., Colo.*, 138 B.R. 973, 979 (Bankr. D. Colo. 1992) ("the 'creditor protection' provided by section 109(c)(5), as interpreted by this Court, insures that the creditors have an opportunity to negotiate concerning a plan on a level playing field with the debtor before their rights are further impaired by the provisions of section 362 of the Code").

45. In *Sullivan County*, the court found that the debtor did not negotiate in good faith under section 109(c)(5)(B) because it refused to include one of its significant assets in the negotiations. 165 B.R. at 78. "In fact, [the debtors] ignored any timely resort to their primary asset resulting in the substantial buildup in the unpaid service fee obligations." *Id.* Thus, the court found that the debtor did not meet section 109(c)(5)(B). *Id.* at 79.

46. Similar to the debtor leaving out a major asset in the negotiations in *Sullivan County*, the City intentionally left out its single largest unsecured liability during the AB 506 process – its CalPERS liability. The City estimates its CalPERS liability to total $245 million over the next ten years. *See* Ask at 65. In fact, CalPERS projects that pension plans it administers for City employees and retirees are underfunded by an astonishing $413 million. *See* CalPERS Actuarial Valuation as of June 30, 2010 at 5 (Miscellaneous Plan of the City of Stockton), a true and correct copy of which is attached to National's Exhibit Index filed herewith as <u>Exhibit F</u>, and CalPERS Actuarial Valuation as of June 30, 2010 at 5 (Safety Plan of the City of Stockton), a true and correct copy of which is attached to National's Exhibit Index filed herewith as <u>Exhibit G</u> (together, the "<u>CalPERS Actuarial Valuations</u>"). As stated in the City's Eligibility Pleadings, such liability is "a major contributing factor to the City's cash and budget crisis." *See* Ex. P to Montes Decl. at 41.

47. Despite the City's massive CalPERS liability, the City did not even ask for any reductions from CalPERS, which is the very liability that the City blames for its financial situation, and apparently did not mediate with CalPERS since representatives of CalPERS attended only two introductory meetings on April 30, 2012 and May 1, 2012 and one additional meeting on June 8 "to

discuss retirement benefits" with the City's police unions. *See* Levinson Decl., Ex. B. In contrast, the City proposed a plan whereby most of the City's other general unsecured creditors, including National, would be substantially and deeply impaired.

48. This did not need to be the case. Given that the PERL permits CalPERS to terminate the City's contracts and transfer its plan assets and liabilities to the terminated agency pool (as discussed above) the City could have, at a minimum, requested CalPERS to do so and attempted to negotiate reduced contribution rates for existing and future retirees.

49. Despite the presence of a CalPERS representative during the AB 506 process, CalPERS was not asked by the City to make any concessions and the Ask provides no explanation or justification as to why similarly-situated creditors were asked to take reductions while CalPERS was not. As set forth in the Levinson Declaration, CalPERS was invited to and did participate in the AB 506 process. *See* Levinson Decl., Ex. A. Representatives of CalPERS attended the initial AB 506 meetings on April 30, 2012 and May 1, 2012 and one additional meeting on June 8. *See* Levinson Decl., Ex. B. However, the City elected not to engage in mediation with CalPERS and does not even list CalPERS in its Outcome of AB 506 Mediation Sessions. *See* Levinson Decl., Ex. C. As the court held in *Ellicott School Building Authority* that meaningful negotiations are required under section 109(c)(5)(B), the City's leaving out a major creditor from the negotiations, *i.e.*, CalPERS, cannot be said to be meaningful negotiations in any sense.

2. Negotiations with CalPERS Were Not Impracticable under Section 109(c)(5)(C)

50. The City cannot argue that as an alternative to section 109(c)(5)(B), that it meets section 109(c)(5)(C) of the Bankruptcy Code, which provides that "[a]n entity may be a debtor under chapter 9 of this title if and only if such entity … is unable to negotiate with creditors because such negotiation is impracticable." 11 U.S.C. § 109(c)(5)(C). The City's Eligibility Pleadings demonstrate that negotiations with CalPERS were not impracticable. To the contrary, CalPERS was invited to and, in fact, did participate in the AB 506 process. The City simply elected not to enter into mediation with them.

51. Whether negotiations with creditors are impracticable depends on the circumstances of the case. *City of Vallejo*, 408 B.R. at 298. "'Impracticable' means 'not practicable; incapable of being performed or accomplished by the means employed or at command; infeasible.' In the legal context, 'impracticability' is defined as 'a fact or circumstance that excuses a party from performing an act, [especially] a contractual duty because (though possible) it would cause extreme and unreasonably difficulty.'" *In re Valley Health Sys.,* 383 B.R. at 163.

52. "Impracticable" under section 109(c)(5)(C) is clearly not intended to apply to participants in the AB 506 process. Colliers notes that

> This alternative was inserted in the 1976 Act as a means of dealing with the difficult problems created by major municipalities, such as New York City, whose bonds are exceedingly numerous and are frequently in bearer form. Under these circumstances, negotiation is difficult at best, because of the extreme difficulty in identifying the creditors with whom the municipality must negotiate.

6 *Collier on Bankruptcy* ¶ 900.02[2][e][iii] (16th ed. 2010).

53. Here, negotiations with CalPERS were not "incapable of being performed or accomplished." CalPERS was invited to and did attend the AB 506 process. *See* Levinson Decl, Ex. A. The City cannot demonstrate that negotiations with CalPERS were "unreasonably difficult" and, thus, impracticable under section 109(c)(5)(C) as CalPERS was a participant in the AB 506 process but the City simply failed to request any concessions from them. In fact, by the City's own admissions <u>no</u> negotiations occurred because the City actually elected not to seek concessions from CalPERS. Accordingly, the City cannot argue that it does not need to satisfy the good faith negotiation requirement in section 109(c)(5)(B).

3. <u>The AB 506 Negotiations Did Not Relate to a Feasible "Plan" that is in "the Best Interests of Creditors" as Required by Section 109(c)(5)(B)</u>

54. The City also does not meet the requirements of section 109(c)(5)(B) because the City did not present a feasible plan that is in the best interest of creditors in the AB 506 process negotiations. It is not sufficient for a debtor to have generally engaged in negotiations regarding the debts owed. Rather, the debtor must have engaged in good-faith negotiations with its creditors

concerning the terms of a plan of adjustment to be proposed under section 941 of the Bankruptcy Code. *See, e.g., City of Vallejo*, 408 B.R. at 296-97 (complete plan not required, but outline or term sheet of plan designating classes of creditors and treatment is necessary).

55. Notably, the plan or terms of a plan that is proposed must be a plan that can be effectuated in chapter 9. *See Sullivan County*, 165 B.R. at 78 (debtors failed to meet their burden of showing that they negotiated in good faith because the plan that was proposed was not a plan that could be effectuated in chapter 9); *In re Cottonwood Water and Sanitation Dist.,* 138 B.R. at 979 (finding that "in order for this Debtor to be entitled to the entry of an order for relief, it must be prepared to show that it engaged in good faith negotiations with its creditors concerning the possible terms of a plan to be effected pursuant to section 941 of the Bankruptcy Code").

56. In *Sullivan County*, the Bankruptcy Court for the District of New Hampshire found that the debtors had not negotiated with their creditors in good faith prior to filing for bankruptcy under section 109(c)(5)(B) because the debtors did not propose or attempt to come up with a plan that could be effectuated in chapter 9. 165 B.R. at 78. The court emphasized that even in the weeks immediately before the petition date, the debtors failed to exert efforts that were required to meet their obligations. *Id.* at 79. The court further stated as follows:

> Under the statutory provision the Districts were also required to negotiate regarding a "plan" to deal with their financial problems. <u>The record establishes that at no time prior to the Chapter 9 filing did the Districts set out for Wheelabrator, or any other creditor for that matter, a comprehensive workout plan dealing with all of their liabilities and all of their assets in terms comparable to a plan of adjustment that could be effectuated under Chapter 9 of the Bankruptcy Code</u>. While the statutory requirement does not require a formal plan as such, some sort of comprehensive plan is required as one of the "screening factors" to avoid a too early and rapid resort to the bankruptcy courts by municipalities. 4 *Collier on Bankruptcy* par. 900.03 (15th ed.); 6 *Norton Bankr.L. & Prac.* § 136.25 (1993). <u>It has been held that good faith negotiations per se are not sufficient to meet the statutory requirement unless they revolve around the negotiating of the terms of a plan that could be effectuated if resort is required to Chapter 9 of the Bankruptcy Code.</u>

Id. at 78 (emphasis added).

57. Here, the Ask is clearly not a plan -- or even an outline of a plan -- that could be effectuated in chapter 9 because it cannot meet the test of "feasibility" under section 943(b)(7) to be confirmed by the Court. *See In re Mount Carbon Metro. Dist.,* 242 B.R. 18, 35 (Bankr. D. Colo.

1999) (finding that a feasible plan "should offer a reasonable prospect of success and be workable"). The terms of the Ask itself are fatal to the City's argument for eligibility. As stated above, even if all concessions in the Ask are achieved, the failure of the City to propose any adjustment to its CalPERS liability results, in the City's own forecasts, in an annual deficit starting as early as 2013-14 of over $5 million, growing alarmingly to over $17 million annually by 2020-21. The City in fact projects a total deficit under its own plan and over its own projection period of nearly $100 million, a staggering amount. *See* Ask at 58. The City concedes in the Ask that its plan is not feasible, stating that "[u]nfortunately, while the AB 506 proposal savings is absolutely necessary, it alone is not sufficient to close the City's ongoing budget gap." Ask at 58. The City admits it will remain insolvent under its own plan:

> The challenge is that the total savings from the City's proposals, alone, is not enough to get the City to financial health, <u>and indeed is not even enough to match our best-case projected deficit</u>. Further, none of these outcomes produces sufficient net resources for a General Fund reserve, which is essential for the City's fundamental fiscal security. Finally, even if the City <u>were</u> to achieve a balanced budget at the "stabilized" level ("baseline plus adds"), <u>that budget would remain insolvent</u>…

Id. at 60 (first and third emphasis added).

58. In fact, the City reveals that it has proposed <u>no strategy</u> to resolve its fiscal problems. Rather than face the hard realities imposed by its unbearable liability to CalPERS the City takes a pass:

> Appropriate budget strategies will be developed in the fiscal year FY 2012-13 budget process and subsequent years to close the [budget] gap…

Id. at 60.

59. The Ask could also not be confirmed as a plan of adjustment under chapter 9 because the concessions demanded under the City's debt instruments are disproportionate to concessions demanded from similarly situated creditors and appear to be arbitrary at best. Thus the Ask is not "in the best interests of the creditors" and could not be confirmed under section 943(b)(7). In the chapter 9 context, the "best interests of creditors" test has generally been interpreted to mean that the plan must be better than other alternatives available to the creditors. *See* 6 *Collier on Bankruptcy* ¶

943.03[7][a] (16th ed. 2010). The courts generally apply the test to require a reasonable effort by the municipal debtor that is a better alternative for its creditors than dismissal of the case. *Id.*

60. As shown above, while debt service savings account for 44% of the concessions sought by the Ask, total debt service represents only 7.5% of the City's baseline expenditures projected for 2012-13. *See* Ask at 65-67 and Exhibit A attached hereto. And despite an annual liability to CalPERS of $17 million increasing to over $30 million during the City's projection period and a staggering current unfunded liability of over $413 million, *see* CalPERS Actuarial Valuations, the City has not requested a dollar of concessions from its single largest general unsecured creditor.

61. Therefore, because the City has admitted that the Ask "is not sufficient to close the City's ongoing budget gap" and "not enough to get the City to financial health" and insists on sheltering its single largest unsecured creditor at the expense of all other similarly situated creditors, the City has not met its burden under section 109(c)(5)(B) and proved that it has negotiated in good faith with its creditors. The Ask is not feasible and is not in the best interests of creditors and, if it constituted the terms of a plan of adjustment, could not be effectuated in chapter 9. Further, the protection of CalPERS benefits for the Mayor, city council and other City employees is clearly not in good faith. Accordingly, because the City has not met the requirements of section 109(c)(5)(B), this Court must dismiss the City's chapter 9 petition. [7]

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[7] The City would also not be able to confirm the Ask as a so-called "cramdown plan" under section 1129(b) of the Bankruptcy Code. Section 1129(b) provides that the court may confirm a plan of reorganization over the objection of creditors if "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." Thus, in order to obtain approval of the Ask as a cramdown plan, the City would need to prove that the Ask does not "discriminate unfairly," even though one or more classes of creditors have voted against it. Courts have denied confirmation of a plan that proposed disparate treatment of similarly situated creditors as unfairly discriminatory. *See In re Tucson Self-Storage*, Inc., 166 B.R. 892, 898 (9th Cir. BAP 1994) ("A plan discriminates unfairly if it singles out the holder of some claim or interest for particular treatment."); *In re Caldwell,* 76 B.R. 643, 646 (Bankr. E.D. Tenn.1987) (denying confirmation of plan where plan proposed to pay class of unsecured credit card claims 100%, but proposed to pay class of all other unsecured claims only 22.7%); *In re Johns–Manville Corp.,* 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986), *aff'd,* 78 B.R. 407 (S.D.N.Y.1987), *aff'd,* 843 F.2d 636 (2d Cir. 1988) ("[A] plan proponent may not segregate two similar claims or groups of claims into separate classes and provide disparate treatment for those classes."). Thus, given that the Ask "singles out the holder of some claim or interest" – CalPERS -- for favorable treatment, the Ask discriminates unfairly against other similarly situated creditors and could not be confirmed as a cramdown plan under section 1129(b).

B. The City Did Not File the Petition in Good Faith

62. The City did not file its chapter 9 petition in good faith; thus, its chapter 9 case should be dismissed. *See* 11 U.S.C. § 921(c). Section 921(c) provides: "After any objection to the petition, 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." *Id.*

63. "Good faith is not defined in the Bankruptcy Code nor is there any meaningful discussion of the Congressional intent behind the good faith requirement found in the legislative history of this section." *In re Sullivan County*, 165 B.R. at 80. However, while the requirement to file the petition in good faith under section 921(c) is distinct from the requirement to negotiate in good faith under section 109(c)(5)(B), "these statutory provisions do involve considerable overlapping from an evidentiary standpoint." *Id.* In *Sullivan County*, the court found that the debtors did not file their petition in good faith under section 921(c) for many of the same reasons that it found that the debtors did not meet section 109(c)(5)(B) and concluded that "[t]he debtors in the present case have failed to establish the requisites for Chapter 9 relief, both under § 109(c) and § 921(c), and therefore their petitions *must* be dismissed under the former and *should* be dismissed under the latter." *Id.* at 83.

64. Here, similar to *Sullivan County*, the City has failed to meet the good faith requirements under section 921(c) and section 109(c)(5)(B). As previously discussed, the City has not presented evidence that it negotiated with its creditors equitably and thus, in good faith. The Ask clearly demonstrates the City's favorable treatment of CalPERS, its single largest unsecured creditor, to the detriment of other similarly-situated creditors, including National. Further, by the City's own admission, the Ask is not a plan that is feasible and in the best interests of creditors and that can be confirmed in chapter 9. Accordingly, the City's chapter 9 petition should be dismissed.

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WHEREFORE, National respectfully requests that this Court issue an Order (i) dismissing the City's chapter 9 petition and (2) granting such other and further relief as is just and proper under the circumstances.

Dated: August 8, 2012

WINSTON & STRAWN LLP

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