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Jeffrey E. Bjork (Cal. Bar No. 197930)
Christina M. Craige (Cal. Bar No. 251103)
SIDLEY AUSTIN LLP
555 West Fifth Street, Suite 4000
Los Angeles, California 90013
Telephone: (213) 896-6000
Facsimile: (213) 896-6600
Email: jbjork@sidley.com
ccraige@sidley.com

Guy S. Neal (Admitted *Pro Hac Vice*)
Alan C. Geolot (Admitted *Pro Hac Vice*)
SIDLEY AUSTIN LLP
1501 K Street, N.W.
Washington, D.C. 20005
Telephone: (202) 736-8000
Facsimile: (202) 736-8711
Email: gneal@sidley.com
ageolot@sidley.com

Attorneys for Assured Guaranty Corp.
and Assured Guaranty Municipal Corp.

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA
SACRAMENTO DIVISION

In re:) Case No. 12-32118
CITY OF STOCKTON, CALIFORNIA,) DC No. OHS-1
Debtor,) Chapter 9
)
)
) Date: August 23, 2012 (Status Conference)
) Time: 10:00 a.m.
) Courtroom: 35
) Judge: Hon. Christopher M. Klein
)
)

**PRELIMINARY OBJECTION OF ASSURED GUARANTY CORP.
AND ASSURED GUARANTY MUNICIPAL CORP. TO DEBTOR'S
CHAPTER 9 PETITION AND STATEMENT OF QUALIFICATIONS**

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1 Assured Guaranty Corp. and Assured Guaranty Municipal Corp. (collectively, “Assured”)
2 hereby file this preliminary objection (the “Preliminary Objection”) to the City of Stockton’s
3 (“Stockton” or the “City”) chapter 9 bankruptcy petition and, in particular, to the City’s Statement
4 of Qualifications under Section 109(c) of the Bankruptcy Code. The City has not established that it
5 (i) is insolvent under 11 U.S.C. § 109(c)(3); (ii) has satisfied the negotiation requirement contained
6 in 11 U.S.C. § 109(c)(5); (iii) has negotiated in “good faith” under Cal. Gov’t Code § 53760.3(o),
7 which is a requirement for specific authority under Cal. Gov’t Code § 53760(a) to be a debtor
8 under 11 U.S.C. § 109(c)(2); and (iv) has filed its petition in “good faith” under 11 U.S.C.
9 § 921(c). If, following discovery, the evidence demonstrates that the City cannot satisfy one or
10 more of these eligibility factors, Assured requests that the City’s petition should be dismissed.

11 This Preliminary Objection is based on the following Memorandum of Points and
12 Authorities, along with all pleadings and papers on file in this action, the evidence to be developed
13 during discovery, and upon such other matters as may be presented to the Court at the time of the
14 hearing and evidentiary trial on eligibility.¹

15 MEMORANDUM OF POINTS AND AUTHORITIES

16 I. INTRODUCTION

17 Assured has provided significant financial benefit to Stockton. As a municipal bond
18 insurer, Assured “wraps” a municipal bond with a guarantee that benefits the municipality by
19 allowing it to take advantage of Assured’s creditworthiness by paying a lower interest rate on the
20 insured bond than it would have otherwise. At the same time, bond insurance gives bondholders
21 (including mutual funds and institutional and individual investors) the comfort of knowing that
22 Assured will step into their shoes² and thereby make them whole in the event the City defaults.

23 ¹ In keeping with this Court’s analogy of an eligibility objection to an answer in civil litigation,
24 Assured has not submitted additional, affirmative evidence at this stage. Assured reserves the right
25 to supplement this Preliminary Objection with additional legal and evidentiary bases following the
conclusion of discovery.

26 ² Because Assured would be required to step in and repay the holders of the insured bonds if the
27 City fails to do so, Assured is the true economic party in interest with respect to those bonds.
Further, as more fully set forth in the related bond documents, Assured has the right to pursue the
28 remedies of insured bondholders by directing the actions of Wells Fargo Bank, National
Association, as trustee under the applicable indentures of trust and other related documents.

1 Thus, bond insurance creates a long-term relationship between the bond insurer and the
2 municipality. Although it agreed to enhance the City's credit as to certain bonds, Assured did not
3 market or sell any bonds in this case, and it is not a securities underwriter, investment bank or
4 hedge fund. Nor is Assured any other kind of "Wall Street" bogeyman, as the City has portrayed.

5 At Stockton's request, Assured essentially lent Stockton its credit rating by providing
6 bondholders insurance for more than \$160 million in Stockton municipal bonds. First, Assured
7 "wrapped" \$125,310,000 in aggregate principal amount of pension obligation bonds ("Pension
8 Obligation Bonds"). The Pension Obligation Bonds refunded a portion of the City's then-nearly
9 \$158.5 million unfunded accrued actuarial liability ("UAAL") as determined in accordance with
10 the terms of the City's contract with the California Public Employees' Retirement System
11 ("CalPERS" and the "CalPERS Contract," respectively). The estimated all-in annual interest cost
12 on the Pension Obligation Bonds is approximately 5.47% (due largely to Assured's strong credit
13 rating), compared to the 7.75% then-assumed investment rate used by CalPERS to calculate the
14 City's payment obligation. The City continues to benefit from the proceeds of the Pension
15 Obligation Bonds because CalPERS (i) continues to hold and invest those proceeds (and still
16 expects to earn 7.5% on them, according to its latest public information) and (ii) uses those
17 proceeds in determining what the City owes under the CalPERS Contract. Second, Assured
18 "wrapped" \$40,770,000 in aggregate principal amount of lease revenue bonds ("Lease Revenue
19 Bonds") issued by the Stockton Public Financing Authority to fund the City's acquisition of an
20 approximately 250,000 square foot, eight story existing office building located at 400 East Main
21 Street in Stockton. The City also benefited from Assured's superior credit rating in securing a
22 substantially lower interest rate on the Lease Revenue Bonds than it would have obtained with the
23 City's credit rating alone.

24 With this significant stake in Stockton's continued success, Assured has a strong financial
25 interest in seeing the City stabilize and thrive. Assured disagrees with the City's decision to file for
26 bankruptcy because Assured is best served by Stockton's long term success, which bankruptcy will
27 only jeopardize. Rather than focusing on Stockton's present *and future*, the City Council has
28

1 allowed short-term politics to drive its decisions, and has used empty rhetoric³ to mask its failure to
2 engage in the difficult, politically unpopular budget decisions and good faith negotiations that
3 would enable the City to solve its problems outside of bankruptcy.

4 **II. BACKGROUND**

5 The Bankruptcy Code imposes substantial eligibility requirements that must be met before a
6 city may be a chapter 9 debtor. “[A]ccess to Chapter 9 relief has been designed to be an
7 intentionally difficult task,” and “[t]he bankruptcy court’s jurisdiction should not be exercised
8 lightly in Chapter 9 cases.” In re Sullivan County Regional Refuse Disposal Dist., 165 B.R. 60, 82
9 (Bankr. D.N.H. 1994) (“Sullivan County”). The City’s submissions to date do not prove eligibility.

10 Based upon Assured’s investigation to date of the information produced by the City, but
11 without the benefit of any formal discovery, it is by no means certain that Stockton is insolvent
12 within the meaning of 11 U.S.C. § 109(c)(3) and therefore eligible for chapter 9 relief. Stockton
13 may well not be insolvent from a cash flow perspective, which is the operative test for insolvency
14 in a chapter 9 case. See In re City of Bridgeport, 129 B.R. 332, 337 (Bankr. D. Conn. 1991).

15 Notwithstanding the thousands of pages that the City produced during the mediation process under
16 Assembly Bill 506 (“AB 506”) and otherwise filed in support of its bankruptcy petition, Stockton
17 has failed to produce – and apparently cannot generate – a reliable cash flow projection.

18 Stockton anchors its bankruptcy petition, its Pendency Plan,⁴ and ultimately its “Ask,” to
19 unaudited and inherently unreliable financials that include budget assumptions and projections that
20 go out 10 years. Yet the City’s own Vanessa Burke admits that “[i]t is not possible to make
21 concrete municipal budgets because there are few, if any, concrete financial facts regarding future
22 economic events, legislative acts, revenues, and expenditures.” Decl. of Vanessa Burke (“Burke

23 _____
24 ³ The City Manager’s assertion that Assured “literally want[s] anarchy in the streets” ignores both
25 the City’s need to address its fundamental problems of excessive salaries and unfunded pension
26 liabilities and Assured’s interest in the City’s financial health. See, e.g., Scott Smith, Creditor
27 Tears Into Stockton, RECORDNET.COM, June 30, 2012, available at
28 http://www.recordnet.com/apps/pbcs.dll/article?AID=/20120630/A_NEWS/206300314/-1/A_SPECIAL0267, and a copy of which is attached as Exhibit A hereto.

⁴ The Pendency Plan (without exhibits) is attached as Exhibit M to the Declaration of Vanessa Burke (Docket No. 64).

1 Decl.”) (Docket No. 62) ¶ 19. Given the City’s inability over the past two years to anticipate its
2 annual budget shortfalls, its projections are particularly suspect.

3 For purposes of chapter 9 eligibility, insolvency cannot be found where, as here, Stockton
4 “deliberately budgets or spends itself into insolvency (so as to qualify under § 101(32)(C)(ii)) when
5 other realistic avenues and scenarios are possible.” In re Town of Westlake Tex., 211 B.R. 860,
6 867 (Bankr. N.D. Tex. 1997). As described below, actions taken by the City Council prior to the
7 bankruptcy only served to exacerbate its problems and strain its liquidity. City officials admit that
8 above-market salary and benefits, unfunded retiree healthcare costs and unfunded pension
9 liabilities, coupled with long-standing financial mismanagement, have driven the City to its current
10 state of distress. See, e.g., City of Stockton’s Proposals for Modifications to Obligations Under AB
11 506 Process (May 7, 2012) (the “Ask”) at 5-8;⁵ Gene Wexler, Stockton, CA mayor responds to
12 Mayor Brown’s remarks, WOKTV.COM, July 20, 2012⁶ (reporting that Mayor Ann Johnston
13 named generous employee salaries, retiree pension benefits, and generous retiree health benefits as
14 “three major problems” and “said pensions and health benefits for retired public employees were a
15 growing problem over the last 20 years”). Indeed, the City’s Vice Mayor Kathy Miller recently
16 remarked that “[i]n Stockton, we took every bad practice and put it into place,” and “[w]e have
17 some safety retirees that are actually earning more in retirement than they earned when they were
18 working because they were able to manipulate the system enough in that last year that they could
19 crank that last year’s income and then get 3 percent times their 25 to 30 years.” Alison Vekshin et
20 al., Police Chief’s \$204,000 Pension Shows How Cities Crashed, BLOOMBERG.COM, July 31,
21 2012.⁷ The City’s financial practices have been so poor that the California State Controller is
22 investigating Stockton’s financial practices and reporting. See Letter of John Chiang to Bob Deis,

23
24 ⁵ The Ask is attached as Exhibit A to the Declaration of David N. Millican (Docket No. 454).

25 ⁶ Available at <http://www.wokv.com/news/news/local/stockton-ca-mayor-responds-mayor-browns-remarks/nPzTs/>, and a copy of which is attached as Exhibit B hereto.

26 ⁷ Available at <http://www.bloomberg.com/news/2012-08-01/police-chief-s-204-000-pension-shows-how-cities-crashed.html>, and a copy of which is attached as Exhibit C hereto. Ms. Miller also noted that “[t]he pensions are so fat that it doesn’t pay them almost to stay on the job. . . . It’s crazy. The system is just completely out of control.” Id.

1 dated April 2, 2012 (the “Chiang Letter”) (discussed infra, at 10).⁸

2 Assured believes the City can pursue viable alternatives to bankruptcy, should it choose to
3 propose serious budget reforms and solutions. These reforms and solutions include reallocating
4 available fund balances, selling non-essential City property, curtailing non-essential City services
5 and privatizing certain others, and raising revenues. These measures, among others, would permit
6 the City to get its financial house in order outside chapter 9. Despite the stigma and anguish this
7 bankruptcy has caused and the negative impact it will have on the City’s future access to the capital
8 markets, it does not appear the City diligently pursued these options. By way of example, the labor
9 concessions that the City just announced it has secured from certain of its labor unions could have
10 been achieved outside of bankruptcy. Additionally, the City has not conducted, to Assured’s
11 knowledge, any polling to determine whether its citizens would vote in favor of revenue
12 enhancement measures to address budget shortfalls. In contrast, both Sacramento and Santa Clara
13 County conducted polling and will request voters to approve tax increases on their November
14 ballots. Chapter 9 is not a substitute for political will. The City must make a distinction between
15 its core functions – the “must haves” – as opposed to the non-core activities – the “nice to haves” –
16 and cut back on the latter amenities. Assured believes the evidence will show that Stockton could
17 have done – and can do – much more to avoid the “last resort” of bankruptcy.

18 Stockton has also failed to demonstrate that it has satisfied the “good faith” requirements of
19 §§ 109(c)(5)(B) and 921(c). The City made no effort to engage in meaningful negotiations with
20 Assured and certain other creditors and refused to negotiate with CalPERS, its largest unsecured
21 creditor. The City targeted its bondholders and left CalPERS and serious labor concessions off the
22 negotiating table. In essence, the City conveyed on its employees the benefit of its booming
23 revenues when times were good and seeks to shift the cost of that decision to the capital markets
24 now that revenues have declined. The City’s own bankruptcy filings reflect that reality. The City
25 has scheduled CalPERS as its largest creditor, and CalPERS’ claim based on the City’s UAAL is

26 _____
27 ⁸ Available at the California State Controller’s website, at http://www.sco.ca.gov/Files-EO/Stockton_audit_letter.pdf, and a copy of which is attached as Exhibit D hereto.

1 currently scheduled at \$147.5 million. This actuarially determined liability severely understates the
 2 City's unfunded liability determined on a market value basis.⁹ Yet the City devotes just one
 3 paragraph to its CalPERS obligation in the Burke Declaration and proposed no alteration
 4 whatsoever to CalPERS' claim in its Ask. See Burke Decl. ¶ 39. By comparison, the City has
 5 proposed to nearly eliminate the Pension Obligation Bonds.

6 The Ask itself is *prima facie* evidence of the City's bad faith. The City's overall bond debt
 7 represents only 8% of the general fund budget, yet accounts for 42% of proposed savings under the
 8 Ask. In contrast, current employees account for the largest share of the general fund budget (51%),
 9 yet only contribute 19% of savings.¹⁰ Although the City blames its predicament in part on an
 10 "excessive debt burden," evidence developed during discovery will demonstrate that the City is not
 11 overleveraged in terms of funded debt. And although the City argues it cannot extract more from
 12 labor because it must "remain competitive," such an assertion defies common sense in a City with
 13 an unemployment rate that, based on the City's own estimations, is as high as 20%.

14 The City has suggested that it requires chapter 9 protection in order to avert disaster. Yet,
 15 denying a municipal bankruptcy petition does not condemn a municipality to ruin, even in the
 16 direst of cases. Several municipalities, including Bridgeport, Connecticut, have successfully
 17 rebounded after the courts rejected their respective chapter 9 petitions. See Patrick M. Fitzgibbons,
 18 Trends in the Region: Two Struggling New England Cities Turn It Around, THE BOND BUYER, Oct.
 19 16, 1995, a copy of which is attached as Exhibit E hereto. Thus, a city can often resolve its

20 _____
 21 ⁹ CalPERS alone sets the value of the UAAL, based on numerous calculations and assumptions
 22 over which the City has no control. See generally Exhibit Q to the Declaration of Laurie Montes
 23 (Docket No. 26) at 251.22-23 (hereinafter "February Update"). CalPERS itself estimates the
 24 underfunded liability as of June 2010 at \$413 million. See CalPERS Actuarial Valuation as of
 25 June 30, 2010 at 5 (Miscellaneous Plan of the City of Stockton); CalPERS Actuarial Valuation as
 of June 30, 2010 at 5 (Safety Plan of the City of Stockton). Copies of both reports are attached as
 Exhibits F and G to Exhibits A – G In Support of "National Public Finance Guarantee
 Corporation's Objection to the City of Stockton's Qualifications Under Section 109(c)" (Docket
 No. 478). Assured has requested an updated value from the City and CalPERS, but they have not
 yet provided one.

26 ¹⁰ The updated figures contained in the City's Pendency Plan support the inequity of the City's
 27 proposals: although the City's overall bond debt represents only 7% of the general fund budget for
 2012-13, it represents 40% of proposed savings for that year. In contrast, current employees enjoy
 approximately 50% of the general fund budget for 2012-13, but only contribute 20% of savings.

1 problems outside chapter 9, even when a city council perceives it has no viable option besides that
 2 extreme route. Indeed, the Mayor of Vallejo has recently lamented that his city filed for
 3 bankruptcy and believes that it could have reached comparable concessions at a lower cost outside
 4 the bankruptcy process. See Phil Willon et al., Rising Costs Push California Cities to Fiscal Brink,
 5 LATIMES.COM, July 12, 2012.¹¹

6 The current City Council blames the City's present situation on decisions made by councils
 7 past, but this City Council's decision to file for bankruptcy and attempt to evade the City's bond
 8 debt sets the stage for present and future hardship for Stockton and its citizens. By jeopardizing the
 9 City's access to the capital markets,¹² the current City Council gives a familiar excuse to a future
 10 city council – "It's not our fault; they did it." Based on its review of the City's materials, Assured
 11 believes that Stockton entered bankruptcy at the wrong time, for the wrong reasons, and does not
 12 satisfy the legal standards for eligibility.

13 III. LEGAL STANDARD

14 As this Court noted, "[f]ive essential elements for eligibility to be a chapter 9 debtor are set
 15 forth at 11 U.S.C. § 109(c), to which is appended a good faith filing requirement by 11 U.S.C.
 16 § 921(c)." Opinion on Motion for Leave to Introduce Evidence Relating to Neutral Evaluation
 17 Process Under California Government Code § 53760.3(q), at 4:2-4 ("Mem. Op'n") (citing 2 Collier
 18 on Bankruptcy ¶ 109.04 (Alan N. Resnick & Henry J. Sommer eds. 16th ed. 2011) ("Collier").

19 The debtor bears the burden of establishing eligibility. See, e.g., Mem. Op'n at 5:22-24
 20 (citing cases);¹³ Sullivan County, 165 B.R. at 75. Although the statute does not set forth the

21 ¹¹ Available at <http://articles.latimes.com/2012/jul/12/local/la-me-san-bernardino-bankruptcy-20120712>, and a copy of which is attached as Exhibit F hereto.

22 ¹² As an example, press reports indicate that Stockton will need \$156 million to modernize its
 23 sewer treatment facilities. That would traditionally be financed in the municipal bond market.
 24 Scott Smith, Rolling the Dice – Bankrupt Stockton May Have to Seek a Loan to Repair its Ricketty
 25 Sewage Treatment System, RECORDNET.COM (July 17, 2012), available at
http://www.recordnet.com/apps/pbcs.dll/article?AID=/20120717/A_NEWS/207170317, and a copy
 of which is attached as Exhibit G hereto.

26 ¹³ While this Court left open the question of whether a debtor carries the burden on "good faith"
 27 under § 921(c), this Court acknowledged the practical reality that the City could not likely prove
 that it negotiated with creditors in good faith under § 109(c)(5)(B) without also satisfying the
 standard of § 921(c). See Mem Op'n at 5 n.1.

1 specific standard of proof, “access to Chapter 9 relief has been designed to be an intentionally
 2 difficult task.” *Id.* at 82; see also *In re Cottonwood Water & Sanitation Dist.*, 138 B.R. 973, 979
 3 (Bankr. D. Colo. 1992) (“Congress consciously sought ‘to limit accessibility to the bankruptcy
 4 court’ by municipalities.”). As Stockton’s bankruptcy counsel have acknowledged, chapter 9 is the
 5 last resort for insolvent municipalities, “to be effected only after every effort has been made to
 6 avoid it.” John Knox and Marc Levinson, Municipal Bankruptcy, Avoiding and Using Chapter 9
 7 in Times of Fiscal Distress, ORRICK.COM (2009) at 3.¹⁴ Given Congress’s intention that chapter 9
 8 be a last resort and the bankruptcy court’s relatively limited powers once an order for relief has
 9 been entered, “[t]he bankruptcy court’s jurisdiction should not be exercised lightly in Chapter 9
 10 cases.” *Sullivan County*, 165 B.R. at 82.

11 IV. ARGUMENT

12 The sole issue before this Court is whether the City has carried its burden of demonstrating
 13 that it is eligible to be a chapter 9 debtor. Despite the barrage of paper the City has submitted in
 14 support of its petition, the City’s materials are largely unresponsive to the relevant legal standards.
 15 Specifically, the City has not yet carried its burden – and ultimately may not carry its burden – of
 16 demonstrating that it:

- 17 • is “insolvent,” as “specially defined for chapter 9 purposes,” Mem. Op’n at 4:18
 18 (citing 11 U.S.C. §§ 101(32)(C) & 109(c)(3); 2 Collier ¶ 109.04[3][c]).
- 19 • satisfies one of the four alternatives for meeting the creditor negotiation
 20 requirement, specifically that it either “negotiated in good faith with creditors” or
 21 that such negotiation was impracticable, Mem. Op’n at 5:4-5 (citing 11 U.S.C.
 22 § 109(c)(5));
- 23 • negotiated in “good faith” under Cal. Gov’t Code § 53760.3(o), which is a
 24 requirement for specific authority under Cal. Gov’t Code § 53760(a) to be a debtor
 25 under 11 U.S.C. § 109(c)(2); and
- 26 • filed its bankruptcy petition in good faith under 11 U.S.C. § 921(c), see In re Valley
 27 Health Sys., 383 B.R. 156, 160 (Bankr. C.D. Cal. 2008) (section 921(c) requires
 28 dismissal if debtor is not eligible for relief under Chapter 9).

25 If the City is unable to satisfy its burden on one or more of the foregoing eligibility requirements,

27 ¹⁴ Available at <http://www.orrick.com/fileupload/1736.pdf>, and a copy of which is attached as
 28 Exhibit H hereto.

1 Assured requests that this Court dismiss the City's bankruptcy petition.

2 **A. Stockton Has Failed To Demonstrate That It Is Insolvent.**

3 Bankruptcy Code § 109(c)(3) provides that a municipality is eligible to be a chapter 9
4 debtor "if and only if . . . [it] is insolvent." Section 101(32)(C) defines "insolvent" for purposes of
5 chapter 9 as "financial condition such that the municipality is--(i) generally not paying its debts as
6 they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its
7 debts as they become due." There is no question that Stockton is in financial distress like the many
8 other cities grappling with high foreclosure levels, declining home prices, high unemployment,
9 improvident labor contracts, unfunded (and in some cases unauthorized) pension and other post-
10 employment benefit liabilities. But financial distress alone does not render a city "insolvent," and
11 courts have denied access to chapter 9 to distressed municipalities unable to meet the standard set
12 forth in § 101(32)(C).

13 **1. Stockton Has Failed To Prove It Is Currently Insolvent.**

14 As a preliminary matter, Stockton cannot demonstrate insolvency by arguing that, on the
15 petition date, it was "generally not paying its debts as they become due." Although the City asserts
16 that it failed to make certain "bond payments and separation payments to retiring City employees,"
17 it does not quantify the amounts at issue. See City of Stockton's Memorandum of Fact and Law in
18 Support of Its Statement of Qualifications Under Section 109(c) of the United States Bankruptcy
19 Code ("Eligibility Brief") at 24. There is no question that the City chose to fund its payroll, retiree
20 health premiums, and other general operating expenses pre-petition. The City's purposeful refusal
21 to make a few debt service payments comprising a relatively small part of the City's budget does
22 not satisfy the definition of "insolvent" under 11 U.S.C. § 101(32)(C)(i). See, e.g., Uecker &
23 Assocs. v. Tenet Healthsystem Hosps., Inc. (In re West Contra Costa Healthcare Dist.), No. 06-
24 41774 T, 2010 Bankr. LEXIS 994, at *8 (Bankr. N.D. Cal. Mar. 26, 2010) (failure to pay \$1.3
25 million out of \$10-\$11 million total operating expenses did not mean the debtor was "generally not
26 paying its debts as they come due").

1 **2. Stockton Has Failed To Produce Reliable Evidence Of Its Current**
2 **And Short-Term Cash Position To Prove Prospective Insolvency.**

3 Section 101(32)(C)(ii) requires Stockton to prove that it will be cash insolvent in the
4 coming fiscal year, not merely budget insolvent. In In re City of Bridgeport, the court analyzed the
5 statutory construction and legislative history behind 11 U.S.C. § 101(32)(C) and concluded that a
6 budget gap and extraordinary financial difficulties do not equal “insolvency” under chapter 9. See
7 129 B.R. 332 (Bankr. D. Conn. 1991). A municipal debtor must prove – *on a cash flow basis* –
8 “that it will be unable to pay its debts as they become due in its current fiscal year or, based on an
9 adopted budget, in its next fiscal year.” Id. at 338. The Bridgeport court dismissed the petition
10 because, although Bridgeport was in “deep financial trouble” and might become “insolvent” in the
11 next few years, it failed to satisfy 11 U.S.C. § 101(32)(C)(ii). Id. at 339. Like Bridgeport,
12 Stockton may be able to show that it is in “deep financial trouble” and may need to seek
13 bankruptcy protection in the future. However, it cannot be a chapter 9 debtor now unless it can
14 prove with detailed and reliable financial information that it cannot access the cash needed to meet
15 its enforceable payment obligations in the current fiscal year.

16 The City’s ability to meet its burden is questionable. The City has not submitted reliable
17 evidence of its actual cash position, because the City has failed to produce either a certified audited
18 financial report for fiscal year (“FY”) 2010-2011 (due October 18, 2011) or a detailed and reliable
19 cash flow projection. The City’s Baseline Budget, while detailed, is unreliable because it is based
20 on unaudited financials.

21 In his April 2, 2012 letter to City Manager Bob Deis, State Controller John Chiang cited the
22 City’s failure to “compl[y] with state laws regarding the timely submittal of annual financial
23 transactions reports” for FY 2010-2011. In addition, State Controller Chiang found “several
24 discrepancies” in the City’s FY 2009-2010 reporting that “raise serious questions regarding their
25 reliability.” Based on the foregoing, “I have concluded that there is reason to believe that the
26 City’s ability to provide reliable and accurate financial information relating to the required
27 financial reports is questionable.” See Chiang Letter.

28 Based on the evidence submitted to date, Assured believes that the City may only be able to

1 demonstrate that, like Bridgeport, it has budgeted itself towards insolvency through the poor
2 choices this City Council has made and continues to make. As discussed further below, the City
3 continues to fund unnecessary expenditures and has failed to pursue achievable revenue
4 enhancements. As chapter 9 is the absolute “last resort” for a municipality that has exhausted all
5 other viable options in curing its financial distress, the City’s failure to take achievable steps to
6 avert bankruptcy demonstrates that its filing is at best premature and should be dismissed.

7 **3. Stockton Has Not “Exhausted All Other Options.”**

8 Chapter 9 does not give Stockton a free pass to vaporize its bond debt based on faulty and
9 unreliable 10-year projections (which fully preserve the City’s obligation to CalPERS), when
10 available non-bankruptcy alternatives exist. Section 109(c)(3)’s insolvency requirement mandates
11 that City leaders must first behave with the necessary financial discipline and solve future problems
12 by making hard present choices to cut services or raise fees. See City of Bridgeport, 129 B.R. at
13 339.

14 The City has the ability to reduce spending and increase revenues outside of bankruptcy,
15 allowing it to remain solvent. Yet Stockton’s City Manager and the City Council have shown that
16 they lack the political will to make the necessary cuts and implement the revenue enhancements to
17 balance the City’s budget for FY 2012-13 and beyond. Rather, the City Council appears to have
18 allowed politics to cloud its approach to the City’s current situation, finding it more politically
19 expedient to attack “Wall Street,” as it calls the entities to which the City once turned for financial
20 assistance, than to develop a feasible, long-term solution to the City’s problems.

21 Chapter 9 was not intended to be utilized as a safety net for such large, poorly managed
22 municipalities seeking quick, short-term relief from financial burdens. A city cannot simply flee
23 into bankruptcy court in order to avoid tough political decisions. Section 109(c)(3)’s insolvency
24 requirement mandates that City leaders must first behave with the necessary financial discipline
25 and solve future problems by making hard present choices to cut services or raise fees. See City of
26 Bridgeport, 129 B.R. at 339. For example, one court concluded there was “insufficient credible
27 proof” of insolvency where a city filed a chapter 9 petition before first implementing cost-cutting
28

1 and revenue-enhancing activities, such as “refiguring road expenses . . . , negotiating with attorneys
2 about fee contracts, approaching developers, seeking business relocations, conserving and
3 maximizing remaining ample funds, etc.” Town of Westlake, 211 B.R. at 867 (observing that
4 “101(32)(C)(ii) does not appear to encompass a situation where a municipality deliberately budgets
5 or spends itself into insolvency...when other realistic avenues and scenarios are possible”). Id.
6 Like the Westlake and Bridgeport debtors, the City has not sufficiently explored “other realistic
7 avenues and scenarios,” and Assured believes the City’s bankruptcy petition should therefore be
8 dismissed.

9 **a. The City Has Not Maximized Revenues.**

10 The City has failed to pursue viable revenue enhancements it is currently authorized to
11 undertake. For example, the City has not pursued \$7 million in issued and uncollected parking
12 tickets.¹⁵ It has also failed to fully explore the sale of non-essential City property, even though the
13 City owns almost 600 pieces of property.¹⁶ Nor has the City reallocated certain available fund
14 balances from its restricted funds to its general fund, even though permitted to do so under
15 applicable law.

16 The City Council has also failed to submit achievable revenue enhancement requests to its
17 citizens, even though it admitted that, “[d]epending on the level of tax increase, the deficits could
18 be erased while maintaining current service levels.” Ask at 60. The City determined that a .25%
19 increase in the sales tax rate alone would generate \$9 million in revenues per year, including \$4.5
20 million in FY 2012-13 if passed on the November ballot. See February Update at 251.26. Other
21 revenue opportunities include an increase in user fees and charges for service, parcel tax, utility
22 user tax, and public parking fees. However, the City has consistently refused to ask its citizens for

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24 ¹⁵ See Laura Cole, Nearly Bankrupt Stockton Has \$7 Million In Uncollected Parking Tickets, CBS
25 SACRAMENTO.COM, June 6, 2012, available at <http://sacramento.cbslocal.com/2012/06/06/stockton-has-7m-in-uncollected-parking-tickets/>, and a copy of which is attached as Exhibit I hereto,
(quoting Vice Mayor Kathy Miller as saying “We could certainly use that \$7 million dollars.”).

26 ¹⁶ See Michael Fitzgerald, Stockton Should Consider Selling Some Of Its Real Estate Bonanza,
27 RECORDNET.COM, May 16, 2010, available at
http://www.recordnet.com/apps/pbcs.dll/article?AID=/20100516/A_NEWS0803/5160313&cid=sit
28 esearch, and a copy of which is attached as Exhibit J hereto.

1 the authority to raise taxes, claiming that tax initiatives would not be approved and that citizens
2 should not have to pay the City's bills. See, e.g., Burke Decl. ¶ 29. The City Council's February
3 Update succinctly summarizes its view: "Even if the voters would approve such a proposal, we just
4 don't think they should be asked to fix this problem, at least until we explore other alternatives,
5 address our liquidation exposure and get our house in order." February Update at 251.3. Even
6 though the citizens voted into office the political leaders that this Council claims created the City's
7 financial mess, this Council thinks that the citizens should not even be *asked* to be part of the
8 solution. In addition, the City Council never asked its citizens to approve a long-term loan to the
9 general fund from the over \$300 million Stockton reportedly holds in restricted funds, which the
10 City admits is permitted under the California Constitution. See Montes Decl. Exh. U at 98 (Table
11 5); Burke Decl. ¶ 17.

12 The City's decisions are motivated by pure speculation about what its citizens want. Unlike
13 other distressed cities, such as Sacramento, Stockton's City Council never polled its citizens on the
14 subject of revenue enhancements. Stockton never gave its citizens the chance to decide whether
15 they would rather implement a minor tax or fee increase or approve an interfund borrowing if
16 doing so could avert the expense, ramifications, and stigma of a bankruptcy filing.

17 **b. The City Has Failed To Make All Necessary Budget Reductions
18 And Has Not Negotiated Reasonable Concessions.**

19 Although the City's pleadings lay the blame for its current predicament at the feet of former
20 Council Members, the current City Council continued to demonstrate fiscal imprudence by failing
21 to take legal and reasonable cost-cutting measures prior to the petition date. Evidence developed
22 during discovery will show that, even in the depths of the recession, the City Council approved
23 wage increases for certain labor groups. In addition, in February 2012, the City Council approved
24 the immediate transfer of approximately \$4.5 million out of and away from the general fund into
25 several restricted funds just as it was preparing to default on payments due on its bonds. See
26 February Update at 251.37. The City also volunteered in 2011 to assume the unfunded liabilities of
27 its redevelopment agency, triggering a \$3.9 million subsidy from the general fund. See Montes
28 Decl. ¶ 36. The City also continues to budget and fund substantial amounts in FY 2012-13 for non-

1 essential City services. See Pendency Plan, Exh. 1 to Resolution 1 (Proposed Budget for General
2 Fund Reflecting Adjustments).¹⁷ These unneeded expenditures and questionable decisions support
3 Assured's concern that the City has merely budgeted itself into insolvency.

4 The City concedes that it approved oversized pay packages to its employees, without a
5 genuine attempt to realign its compensation in light of current economic conditions. The City's
6 continuation of that paradigm in the Ask is irresponsible and driven by politics at the expense of
7 sound financial planning. The City's labor negotiations pre-petition resulted in a delay of salary
8 increases and the elimination of certain excessive benefits,¹⁸ but no actual reductions to base
9 salary. The City continues to treat public employee compensation levels in a vacuum. Evidence
10 developed during discovery will demonstrate that the City's recent deals with its unions are
11 unlikely to bring wages and benefits down to levels the City can sustain. Indeed, Assured believes
12 the City's agreements with labor will track the treatment the City proposed in its Ask, which
13 contains optical, short-term reductions that will be substantially clawed back by labor in the
14 coming years. Compare Ask at 67 (listing "Labor Cost Reductions" of \$5.4-\$5.7 million per year
15 in FY 2015-16 through 2020-21) with id. at 66 (listing "Employee Cost Increases" of \$5-\$19
16 million in FY 2015-16 through 2020-21). Given the actual economic impact of such concessions,
17 Assured believes that they could have been obtained outside of bankruptcy. See Phil Willon et al.,
18 Rising Costs Push California Cities to Fiscal Brink, LATIMES.COM (reporting that Vallejo "ended
19 up with employee contracts that [Mayor] Osby thinks the city could have struck more cheaply if it
20 had stayed out of bankruptcy court and turned to the bargaining table"). In essence, the City has
21 dressed up minor, temporary concessions as a major success of its filing, when it could and should
22 have sought and achieved serious labor reform outside a proceeding.

23 The City could likewise achieve concessions with its other creditor constituencies outside

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25 ¹⁷ Curiously, the City has not filed a copy of its 2012-13 Budget reflecting the adjustments made
26 through the Pendency Plan, a copy of which is attached as Exhibit K hereto. It is also available at
27 http://www.stocktongov.com/files/CouncilAgenda_2012_6_26_PendencyPlan_Item_16_03.pdf.

28 ¹⁸ For example, the City includes as a "concession" by labor the 7-9% employee contribution to
CalPERS, which is now paid by employees instead of the City. See Declaration of Ann Goodrich,
Exh. A.

1 of bankruptcy. For example, the City could alter – as it has in the past – its retiree health program
2 in a way that both provides a substantial savings to the City and maintains coverage for retirees (a
3 solution its retirees would presumably prefer over the treatment contemplated by the City’s
4 Pendency Plan). Further, Assured has made clear that it is willing to engage in substantive
5 negotiations regarding the bonds it has insured, but the City must come to the bargaining table with
6 a fair and realistic approach, divorced from political gamesmanship. Assured has also offered and
7 continues to offer the City its assistance and that of its retained experts – who have led distressed
8 municipalities through successful, non-bankruptcy restructurings – in developing a long-term
9 strategy to address the City’s financial issues. The City has declined each of Assured’s suggestions
10 to date.

11 The City should explore the cost-cutting and revenue-enhancing opportunities discussed
12 above, all of which could be accomplished without taking one police officer off the streets or
13 eliminating a single firefighter. The City is ineligible to be a chapter 9 debtor until the City first
14 pursues these other real opportunities and alternatives to bankruptcy.

15 **B. Stockton Has Failed To Satisfy The Bankruptcy Code Requirement Of**
16 **Negotiating With Creditors.**

17 The City contends it satisfied the negotiation requirement contained in 11 U.S.C.
18 § 109(c)(5) either because (i) negotiations were impracticable or (ii) it conducted negotiations in
19 good faith. Stockton has failed to prove it met either prong of the test.

20 **1. Negotiations Were Not Impracticable Under § 109(c)(5)(C).**

21 The City argues that its negotiations were unlikely to succeed “because (1) the number of
22 parties competing for too few dollars made it highly unlikely that a global restructuring plan would
23 be achieved in a voluntary setting; and (2) it could not bind its numerous retirees to any deal
24 negotiated in the AB 506 process.” Eligibility Brief at 40. Neither argument holds water.

25 First, the City predetermined that its pre-bankruptcy negotiations would fail. The City
26 negotiated from the position of forcing its capital markets creditors to give up a substantial
27 percentage of their recovery to CalPERS and labor – an unprecedented step. As further discussed
28 below, the City refused to negotiate with CalPERS and took the position that the “employees and

1 the citizens of Stockton who receive city services have borne the entire brunt of [the City's]
2 restructuring efforts so far and now its time for others to do the same." February Update at 251.3
3 (emphasis in original).

4 Second, despite admitting that tax revenues would add substantial amounts to its bottom
5 line, the City refused to (i) offer revenue enhancements, (ii) cut non-essential services, (iii) seek
6 real concessions from labor, or (iv) explore other creative solutions in order to increase the
7 likelihood a consensual deal could be reached. Cf. Sullivan County, 165 B.R. at 78 ("A
8 commercial party can hardly 'negotiate in good faith' regarding unpaid obligations if it . . . refuses
9 to acknowledge or throw into the negotiating equations a large and significant asset [of assessment
10 powers] that it holds."). Thus, the City chose to limit the dollars available for negotiation. When
11 only a tiny fraction of the pie is left to share, it is unsurprising that negotiations ultimately fail.
12 However, the City cannot satisfy § 109(c)(5) by ensuring such negotiations will fail.

13 Third, the City itself has changed retiree health benefits in the past outside a proceeding and
14 is authorized to do so under the terms of its existing health program. Thus, any argument that it
15 could not bind retirees to a deal is a red herring.

16 **2. Stockton Did Not Negotiate In Good Faith Under § 109(c)(5)(B).**

17 The City also failed to negotiate in good faith with creditors. The City did not engage in
18 meaningful negotiations with certain of its largest creditors (including Assured) and refused to
19 negotiate at all with CalPERS, its largest unsecured creditor.

20 As an initial matter, Stockton did not negotiate with Assured in good faith to reach a
21 satisfactory agreement regarding its debt obligations. In its Ask, the City submitted ten-year
22 projections, on the basis of which it proposed to vaporize over \$124 million in principal amount of
23 UAAL evidenced by the Pension Obligation Bonds. Yet the City has been consistently unable to
24 generate reliable financial information. See, e.g., Montes Decl. ¶ 24 ("Following this update, staff
25 returned to the City Council in May 2011 to work out a mechanism for balancing the fiscal year
26 2011-12 budget. The good news was that the prior years' steep decline was expected to level off (a
27 forecast that proved inaccurate."); Dan Walters, California Just as Insolvent as Bankrupt Cities,
28 THE SACRAMENTO BEE, July 13, 2012 ("As their gaps between income and outgo widened, officials

1 covered them with questionable transfers, bookkeeping gimmicks, loans and lies – hoping against
2 hope that the downturn would be brief and revenue would once again surge and bail them out.”).¹⁹
3 Indeed, in light of the global economic events of the past five years, a ten-year projection cannot
4 form any sort of reliable basis for permanently wiping out 82% of Pension Obligation Bond
5 principal.

6 The City’s bankruptcy counsel creates a false impression that the City received “no
7 counteroffer” from Assured. Decl. of Marc A. Levinson In Support of the City’s Statement of
8 Qualification Under Section 109(c) of the United States Bankruptcy Code (Docket No. 452) at
9 Exh. C, p. 2. When the Court establishes the procedures for disclosure of the negotiations, Assured
10 will demonstrate that the City did not disclose all the terms of its offer and that the City’s statement
11 is not correct. Without disclosing the many statements made between counsel for the parties
12 during the course of the mediation, the reality is that the City received “no counteroffer” from
13 Assured because the City presented its treatment of the Pension Obligation Bonds as its final and
14 best offer.

15 Negotiations require concessions from both sides and collaboration between the debtor and
16 creditors. For example, in In re Ellicott School Building Authority, the court held that even though
17 the debtor conducted three public meetings explaining its proposed plan of restructuring to
18 bondholders, it did not negotiate in good faith because it indicated that the economic terms of the
19 proposed plan were nonnegotiable. 150 B.R. 261, 266 (Bankr. D. Colo. 1992) (“Ellicott”); see also
20 Sullivan County, 165 B.R. at 78-79 (“The ‘creditor protection’ provided by section 109(c)(5) . . .
21 insures that the creditors have an opportunity to negotiate concerning a plan on a level playing field
22 with the debtor before their rights are further impaired . . .”). Like the debtor in Ellicott, Stockton
23 used the City’s dubious budget forecasts (based on unaudited financials) to formulate its Ask and
24 then presented its treatment on the Pension Obligation Bonds on a take-it-or-leave-it basis.

25 The City also failed to negotiate in good faith because it failed to negotiate with CalPERS.
26 While discovery is needed to confirm the substance and extent of the City’s discussions with

27 ¹⁹ Available at <http://www.sacbee.com/2012/07/13/v-print/4628160/dan-walters-california-just-as.html>, and a copy of which is attached as Exhibit L hereto.
28

1 CalPERS,²⁰ Assured suspects that the City at no point proposed or pressed any alteration of its
 2 obligations to CalPERS, nor questioned how CalPERS calculated the City's UAAL. At a
 3 minimum, the City's Ask does not propose any discount to that portion of the UAAL represented
 4 by the CalPERS Contract (which the City scheduled at \$147.5 million), compared to the 82% cut
 5 proposed for the UAAL represented by the Pension Obligation Bonds. In essence, the City seeks
 6 to impose an 82% haircut on repayment of the Pension Obligation Bonds, proceeds of which were
 7 used to refund Stockton's unfunded pension liability, and at the same time not even propose a
 8 reduction in the unfunded liability itself. Assured will demonstrate, if need be, that the Pension
 9 Obligation Bonds and the CalPERS Contract have the same legal character as a matter of
 10 California law, evidenced by a California judgment the City itself sought, and that the Pension
 11 Obligation Bonds and CalPERS Contract evidence one and the same underlying obligation – the
 12 UAAL. The City took the bondholders' money to give to CalPERS, and now proposes to leave
 13 those funds with CalPERS and pay CalPERS everything else CalPERS decides the City owes.
 14 Such actions are certainly not evidence of "good faith."²¹

15 **C. Stockton Did Not Negotiate In "Good Faith" Under Cal. Gov't Code**
 16 **§ 53760.3(o).**

17 Checking the boxes on California's newly-mandated pre-bankruptcy procedure does not
 18 mean the City participated in that process in good faith. Independent of whether the City
 19 negotiated in good faith within the meaning of the Bankruptcy Code, Stockton did not negotiate in
 20 "good faith" within the meaning of AB 506. The City contends it was "specifically authorized" to
 21 be a municipal debtor under California law because it "participated in a neutral evaluation process
 22 pursuant to Section 53760.3." Cal. Gov't Code § 53760(a). Section 53760.3(o) requires the City
 23 to negotiate "in good faith," which is defined as

24 ²⁰ The City lists only one meeting with representatives of CalPERS after the introductory sessions
 25 of the AB 506 mediation process, "to discuss retirement benefits" with Stockton's police union.
 See Levinson Decl. Exh. B at 3.

26 ²¹ Because the City has (i) failed to negotiate with Assured; (ii) chosen not to negotiate with
 27 CalPERS; and (iii) refused to consider anything other than a plan that unfairly discriminates and is
 28 neither feasible nor fair and equitable, the City also cannot carry its burden of demonstrating a
 "desire to effect a plan to adjust the debts it is . . . unable to pay." Mem. Op'n 4:23-24; 11 U.S.C.
 § 109(c)(4).

1 participation . . . in the neutral evaluation process with the intent to negotiate toward a
2 resolution of the issues that are the subject of the neutral evaluation process,
3 including the timely provision of complete and accurate information to provide the
4 relevant parties through the neutral evaluation process with sufficient information, in
5 a confidential manner, to negotiate the readjustment of the municipality's debt.

6 Cal. Gov't Code § 53760.1(d). Assured believes that the City (i) lacked the "intent to negotiate
7 toward a resolution" of a consensual adjustment of its debt with both Assured and CalPERS and
8 (ii) did not "provide complete and accurate information to provide the relevant parties through the
9 neutral evaluation process with sufficient information . . . to negotiate the readjustment of the
10 municipality's debt." Because the City has based its eligibility under 11 U.S.C. § 109(c)(2) on its
11 satisfaction of Cal. Gov't Code § 53760(a), the City's failure to satisfy the independent state law
12 requirement to participate in "good faith" makes the City ineligible to be a chapter 9 debtor under
13 11 U.S.C. § 109(c)(2).

14 **D. Stockton Did Not File In Good Faith Under 11 U.S.C. § 921(c).**

15 Stockton's bankruptcy petition should also be denied because it was not motivated by a
16 proper purpose under chapter 9 and was not filed in good faith. See In re City of Vallejo, 408 B.R.
17 280, 295 (B.A.P. 9th Cir. 2009) ("The evidence needs to show that the 'purpose of the filing of the
18 chapter 9 petition not simply be to buy time or evade creditors.'") (citing Collier ¶ 109.04[3][d]).
19 Rather, discovery will reveal that chapter 9 was predetermined by the City Council, which imposed
20 an artificial time line on all its creditors.

21 City representatives repeatedly stated that the City needed to file for bankruptcy unless it
22 could pass a balanced budget by June 30, 2012. However, the City Charter expressly contemplates
23 that the City Council can operate under a proposed budget after the end of the fiscal year. Section
24 1906 of the City Charter states: "In the event the Council shall fail to adopt the budget by the
25 beginning of the fiscal year, the various amounts proposed in the draft budget shall be deemed
26 appropriated until the Council adopts a budget for the fiscal year." Assured urged the City Council
27 to put forth a draft budget (or a continuing budget resolution) providing the basis for meaningful
28 and long-lasting budget reform. The City ignored these requests and filed for bankruptcy. Rather
than evidencing a legitimate bankruptcy purpose, the City's petition appears motivated by a desire

1 to evade certain liabilities, such as the Pension Obligation Bonds, and to improperly advantage
2 certain creditors, such as current employees and CalPERS. The City's failure to negotiate with
3 Assured and CalPERS further underscores that motivation.

4 A municipal debtor must also seriously explore alternative avenues to bankruptcy before it
5 can file in good faith. See In re New York Off-Track Betting Corp., 427 B.R. 256, 282 (Bankr.
6 S.D.N.Y. 2010); Collier ¶ 921.04[2]. In Sullivan County, several municipal debtors filed a chapter
7 9 petition because they owed \$1.1 million in unpaid service fees for usage of an incinerator facility.
8 165 B.R. at 64. The court found that the debtors neither filed in good faith nor negotiated in good
9 faith because they filed for bankruptcy rather than attempt to exercise their assessment powers to
10 pay debt obligations resulting from years of financial mismanagement. Id. at 78, 82. Like the
11 debtors in Sullivan County, Stockton refused to attempt a revenue solution for the debt it created
12 through years of financial recklessness and thus neither filed nor negotiated in good faith.

13 **V. CONCLUSION**

14 For the foregoing reasons, and subject to discovery, Assured respectfully requests that the
15 Court deny the City's chapter 9 petition and grant such other further relief as the Court may deem
16 proper.

1 Dated: August 9, 2012

Respectfully submitted,

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SIDLEY AUSTIN LLP

/s/ Christina M. Craige

Jeffrey E. Bjork (Cal. Bar No. 197930)
Christina M. Craige (Cal. Bar No. 251103)
SIDLEY AUSTIN LLP
555 West Fifth Street, Suite 4000
Los Angeles, California 90013
Telephone: (213) 896-6000
Facsimile: (213) 896-6600
Email: jbjork@sidley.com
ccraige@sidley.com

Guy S. Neal (Admitted *Pro Hac Vice*)
Alan C. Geolot (Admitted *Pro Hac Vice*)
SIDLEY AUSTIN LLP
1501 K Street, N.W.
Washington, D.C. 20005
Telephone: (202) 736-8000
Facsimile: (202) 736-8711
Email: gneal@sidley.com
ageolot@sidley.com

Attorneys for Assured Guaranty Corp.
and Assured Guaranty Municipal Corp.