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9 UNITED STATES BANKRUPTCY COURT

10 EASTERN DISTRICT OF CALIFORNIA

11 SACRAMENTO DIVISION

12

13 In re:	Case No. 2012-32118
14 CITY OF STOCKTON, CALIFORNIA,	D.C. No. OHS-5
15 Debtor.	Chapter 9
16–20	**CITY OF STOCKTON'S REPLY IN SUPPORT OF MOTION FOR ORDER (1) RULING THAT APPROVAL OF SETTLEMENT AGREEMENT IS NOT REQUIRED UNDER RULE 9019 OF THE FEDERAL RULES OF BANKRUPTCY PROCEDURE; OR ALTERNATIVELY (2) APPROVING SETTLEMENT AGREEMENT PURSUANT TO RULE 9019**
21–23	Date: November 20, 2012 Time: 9:30 a.m. Dept: C, Courtroom 35 Judge: Hon. Christopher Klein

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I. INTRODUCTION

The creditors who objected to the City of Stockton's eligibility to be a chapter 9 debtor filed a limited objection to the Motion For Order (1) Ruling That Approval Of Settlement Agreement Is Not Required Under Rule 9019 Of The Federal Rules Of Bankruptcy Procedure; Or Alternatively (2) Approving Settlement Agreement Pursuant To Rule 9019 (the "Limited Objection" of the "Capital Markets Creditors" to the "9019 Motion" filed by the "City"). The Limited Objection rests on the flawed premise that section 502 of the Bankruptcy Code creates a substantive requirement that bankruptcy courts approve settlements entered into by chapter 9 debtors. This is not the case, and the Limited Objection must fail for that and other reasons.[1]

First, the Limited Objection fails in its attempt to distinguish cases that clearly place the substantive requirement for settlement approval in section 363 (rather than section 502) by drawing a false distinction between the settlement of claims against the City and the settlement of claims held by the City. It offers no reason why section 363 would not apply in the former case even though the property of the City will be used to satisfy the settlement. Nor does it cite a single case discussing, let alone supporting, this distinction. Second, the Limited Objection attempts to stretch section 502 beyond its bounds by arguing that the section 502 requirement that the bankruptcy court determine the amount of disputed claims also creates a substantive requirement that it approve the settlement of such claims under Rule 9019 of the Federal Rule of Bankruptcy Procedure (the "Rules"). This strained interpretation is not supported by either the language of section 502 or any case law. Moreover, even if such an interpretation were adopted, section 502 is inapplicable to the settlement agreement entered into by the City and Christopher Hallon (the "Hallon Settlement Agreement") that is the subject of the 9019 Motion, because no proof of claim has been filed with respect to the claim being settled, and thus neither the City nor any other party has objected to such nonexistent proof of claim.

As outlined in the 9019 Motion, the only section of the Code which provides a substantive requirement for court approval of the settlement of claims is section 363, which is inapplicable in

[1] Unless otherwise noted, all statutory references herein are to the United States Bankruptcy Code, 11 U.S.C. § 101 *et seq*. (the "Code").

chapter 9 cases. *See* 11 U.S.C. § 901(a). Furthermore, even if the Rules could permissibly create substantive requirements, and even if Rule 9019 created a substantive requirement for court approval of settlement agreements, such a requirement could not be applied to a chapter 9 debtor because it would conflict with that municipality's freedom to control its properties and revenues, and to make governance decisions, under section 904.

The City thus requests that the Court enter an order ruling that the City can enter into the Hallon Settlement Agreement without the need for the Court's approval. Alternatively, if the Court determines that such approval is required, the City requests that such approval – which the Limited Objection does not appear to challenge – be granted.

II. ARGUMENT

A. Section 363 Provides The Substantive Requirement For Court Approval Of Settlements Under Rule 9019.

Rule 9019 enumerates the process by which courts determine whether to approve a settlement entered into by the debtor. Like all of the Rules, it is procedural, and as such, it "cannot create a substantive requirement for court approval that does not exist in the Code itself." *In re Telesphere Communications, Inc.*, 179 B.R. 544, 551-52 (Bankr. N.D. Ill. 1994); *see also In re Dow Corning Corp.*, 198 B.R. 214, 246 (Bankr. E.D. Mich. 1996) (Rule 9019 is "merely a rule, [it] can do no more than establish a procedural mechanism for exercising statutory power."). Multiple courts have held that the substantive requirement of court approval of compromises and settlements is found in section 363. *See In re Mickey Thompson Entm't Group, Inc. (Goodwin v. Mickey Thompson Entm't Group, Inc.)*, 292 B.R. 415, 421 (B.A.P. 9th Cir. 2003) (*citing Myers v. Martin (In re Martin)*, 91 F.3d 389, 394-95 (3d Cir. 1996)); *Northview Motors, Inc. v. Chrysler Motors Corp.*, 186 F.3d 346, 351 n. 4 (3d Cir. 1999) ("[A]s a matter of law, Bankruptcy Rule 9019(a), a rule of procedure, cannot, by itself, create a substantive requirement of judicial approval of [a] settlement . . . Section 363 of the Code is the substantive provision requiring court approval."); *In re Sparks*, 190 B.R. 842, 844 (Bankr. N.D. Ill. 1996).

The Limited Objection attempts to distinguish these cases by claiming that there is an "important distinction between the settlement of a claim asserted *against* the City/debtor . . . and a

settlement of a claim held *by* the City/debtor against a third party." Limited Objection, at p. 2 (emphasis in original). This is a distinction without a difference. Section 363(b)(1) governs the debtor's/trustee's authority to "use, sell, or lease . . . property of the estate." The settlement of claims against a municipality plainly involves the disposition of its property just as much (if not more) as would the settlement of claims it held against third parties – which involve the collection of new property by the municipality. The Limited Objection offers no explanation as to why section 363 would apply any less to the settlement of claims against the City, and not surprisingly fails to cite even a single case discussing this distinction.[2] Thus, while *In re Mickey Thompson Entm't Group*, *Northview Motors*, and *In re Sparks* all involved debtors settling their own claims against third parties, the general holding in these cases – that section 363 provides the substantive basis for requiring court approval of settlement of claims by a debtor – is clearly also applicable to the settlement of claims against a debtor.

B. Section 502 Does Not Create A Substantive Requirement That The Court Approve The Hallon Settlement Agreement, And Is Inapplicable In Any Case.

The Limited Objection (at page 3) attempts to manufacture a separate substantive requirement for court approval of settlements by claiming that such a requirement can be found in section 502. This argument fails as well. First, section 502 does not create any requirement for court approval of *settlements*; nor is there any case law suggesting otherwise. Second, even if section 502 could be construed to include the settlement of claims against the City, it is inapplicable in this case. This is because Christopher Hallon, whose lawsuit against the City is resolved under the settlement agreement, has not filed a proof of claim. Since there was no proof of claim to form the basis of an objection, the City has not filed any objection (nor has any other party). Both the filing of a proof of claim and the filing of an objection are required for the application of section 502.

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[2] In fact, *In re The Heritage Organization, L.L.C.*, 375 B.R. 230, 307-08 (Bankr. N.D. Tex. 2007), which the Capital Markets Creditors inaccurately cite for the proposition that section 502 creates a court approval requirement for settlements (discussed below), explicitly *rejected* the argument that there was a distinction between the settlement of claims for and against the chapter 11 estate in holding that Rule 9019 applies equally to both.

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1. Section 502 Does Not Create A Requirement Of Court Approval Of Settlements In Chapter 9.

Section 502(b) provides that where a proof of claim is filed, and an objection is made to such proof of claim, "the court, after notice and a hearing, shall determine the amount of such claim . . . as of the date of the filing of the petition, and shall allow such claim in such amount [with exceptions]." It makes no mention of a requirement that the court approve the settlement of claims against a debtor. Nor does it reference the disposition of the debtor's property (necessary to consummate the settlement), as does section 363. The Limited Objection does not cite a single case reading section 502 to create such a requirement, and further, none of the cases that *expressly* state that the substantive requirement for court approval of settlements is found in section 363 make any mention of section 502 on this issue.

The Limited Objection cites only two cases that it contends establish a link between section 502 and the settlement approval procedure of Rule 9019. As the Court is well aware, the first case, *In re City of Stockton*, 478 B.R. 8 (Bankr. E.D. Cal. 2012)("*Stockton*"), dealt with a motion for an injunction brought by retirees seeking to prohibit the City from implementing unilateral reductions in their health benefits. *Stockton* makes no mention of Rule 9019, and cites section 502 only for the general proposition that filed proofs of claim are deemed allowed unless there is an objection to the claim. *Id.* at 25. The Capital Markets Creditors claim that the settlement and compromise of claims against the City lie at the "core" of the debtor-creditor relationship, and imply that the Court must therefore approve settlements under section 502. But this Court said no such thing. On the contrary, *Stockton* emphasized the "absolute" "limitation" on the Court's authority to interfere with the City's policy choices during a chapter 9 case, subject to two exceptions (neither applicable here): consent or provision in a plan of adjustment. *Id.* at 20.

The second case, *In re The Heritage Organization, L.L.C.*, 375 B.R. 230 (Bankr. N.D. Tex. 2007), also does not hold, as the Capital Markets Creditors imply, that section 502 creates a substantive requirement that courts approve the settlement of claims against a debtor. Rather, the issue in *Heritage Organization* was whether, in a case where one creditor objected to a settlement

of a claim between the debtor and another creditor, section 502 required the court to rule on the claim objection rather than approving the settlement pursuant to the Rule 9019 process. According to that court, reading section 502 to confer (as asserted by the objecting creditor) "not only a right to object to a claim but a right to a ruling would mean that the Court could *never* permit a settlement of a claim objection - the Court would be required to deny the compromise and rule upon the merits." *Id.* at 285. The court rejected this interpretation, and found the settlement at issue to be fair and equitable. Thus, *Heritage Organization* does *not* hold that section 502 creates a substantive requirement for court approval of settlements pursuant to Rule 9019. Rather, it merely holds that the section 502 requirement that the court determine the amount of a claim did not conflict with the court's ability to approve a settlement pursuant to Rule 9019.

By its plain language, section 502 is limited to the determination of the allowability of the amount, if any, of proofs of claim to which the debtor has objected. No portion of section 502 suggests that it would apply to the settlement of claims, and the Capital Markets Creditors cite no case holding that section 502 creates a substantive requirement for Court approval of a settlement of claims.

2. Section 502 Is Not Applicable To Hallon's Claim, Because He Did Not File a Proof of Claim, And Thus There Is No Pending Objection.

Even if the Capital Markets Creditors could show that section 502 created a substantive requirement that the City receive Court approval for the settlement of claims, such a requirement would not apply to the Hallon Settlement Agreement because Hallon has not filed a proof of claim. Nor, it follows, did the City (or any other party) object to the non-existent proof of claim. The notice and hearing requirement of section 502 applies, by its express terms, only where an "objection to a claim is made," upon a claim "proof of which is filed under section 501." 11 U.S.C. § 502(a), (b). Because neither of these pre-requisites has occurred, the Capital Markets Creditors cannot invoke the requirements of section 502. Thus, the Court need not even reach the question of whether section 502 creates a substantive requirement of court approval for settlements of claims.

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3. The City Of Vallejo's Decision To Seek Court Approval For The Settlement Of Claims Against It Has No Bearing On The Application Of Rule 9019 To This Case.

3 In an attempt to deflect attention from its lack of supporting precedent, the Limited
4 Objection notes several instances in which the City of Vallejo sought court approval of the
5 settlement of claims in its own chapter 9 case. Of course, as the Capitol Market Creditors are
6 well aware, the City of Vallejo's decision to take any action, including seeking court approval of
7 its settlements, has no bearing whatsoever on the City, and is completely irrelevant to the
8 question of whether Rule 9019 is applicable to chapter 9 debtors. There are any number of
9 reasons the City of Vallejo may have chosen to seek court approval. For instance, it may have
10 done so out of an abundance of caution or as part of an agreement with its creditors. Moreover,
11 the settlements cited by the Limited Objection all took place near the end of Vallejo's chapter 9
12 case. As such, there was little incentive for it not to seek court approval. By contrast, the City of
13 Stockton hopes to avoid the substantial costs of litigating challenges to each and every one of its
14 settlements throughout its chapter 9 case. For example, when and if the City reaches agreement
15 with the Stockton Police Officers Association ("SPOA"), the only one of its nine unions not to
16 have signed a new collective bargaining agreement, such agreement also will settle the claims of
17 SPOA members on account of the City's prebankruptcy unilateral imposition of compensation
18 reduction measures under two fiscal emergencies. Releases of claims by both parties are a
19 standard part of labor agreements, and often involve trade-offs deeply woven into the fabric of the
20 labor agreement itself – decisions regarding wages and benefits that, as the Court previously has
21 held, are core to a city's municipal powers. The City submits that the Court has no power to, nor
22 should it, dictate to the City the terms of any such agreement with SPOA or its members.

23 Vallejo's decision carries no precedential weight, and court approval of Vallejo's
24 settlements in no way shows that such approval was *required*.[3] Judge McManus in *Vallejo* was
25 not asked to determine, nor did he discuss, let alone determine, the necessity of seeking his
26 approval for these settlements, either in the context of Rule 9019, section 363, or section 502.
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[3] Moreover, each of Vallejo's settlement agreements resolved filed proofs of claim. Even were the Court to find that section 502 requires its approval of settlements, while such a requirement would have applied to the City of Vallejo, it would not apply to Stockton in this instance because Hallon has filed no proof of claim.

The Capital Markets Creditors merely hope to insinuate that because a prior chapter 9 debtor sought court approval of its settlement agreements of its own volition, such approval must have been necessary. The Limited Objection attempts the same inference by citing to *In re Corcoran Hospital District*, 233 B.R. 449 (Bankr. E.D. Cal. 1999), another case in which court approval of a settlement was sought and granted, but which contains no discussion of whether court approval was required and which makes no reference to any purported source of such a requirement.

All told, Vallejo's decision to seek court approval does not bind the City, and does nothing to alter existing precedent – which makes clear that the only substantive requirement for bankruptcy court approval of settlement agreements exists in section 363, a provision that has no application in chapter 9 cases.

C. Any Requirement That The Court Approve The City's Settlement Of Claims Against It Pursuant To Rule 9019 Would Violate 11 U.S.C. § 904.

As discussed in the 9019 Motion, even were the Court to conclude that the City was required to seek its approval of the Hallon Settlement Agreement, such a requirement would improperly conflict with the City's autonomy over its property and revenues, as well as its ability to govern, under section 904. As this Court has stated, section 904 prevents the Court from "interfer[ing] with a municipality regarding political or governmental powers, property or revenues, or use or enjoyment of income-producing property." *Stockton* 478 B.R. at 20.

The Limited Objection contends that section 904 is inapposite because the underlying Hallon case being settled has been stayed pending resolution of the City's chapter 9 case, and thus "the City will not be incurring legal fees in connection with continuing to litigate the case." Limited Objection, at p. 4. While it is true that the City will not incur costs litigating Hallon's claim before the District Court in the short run, this ignores the myriad other impacts that requiring court approval of the Hallon Settlement Agreement (and future settlement of claims) will have on the City's control of its property and revenues. For one, though proceedings before the District Court have been stayed, the City will be forced to incur costs litigating the inevitable motion for relief from the automatic stay as well as stay relief motions by other plaintiffs with whom it could otherwise settle. Moreover, if the City is required to seek the Court's approval of

settlements, then, by implication, the Court would have the authority to reject such settlements. If that were to happen, the City would then have to bear the additional burden of filing an objection to the underlying claim, litigating the amount of the claim, and ultimately incorporating the resolution of that claim into the broader chapter 9 case. Finally, and perhaps most important, the potential rejection of a settlement by the Court itself would interfere with the City's control of its property and revenues. If the City chose to pay out a portion of its funds to settle a claim, enter into new contracts, or take any number of other acts that dispose of City property or affect the City's basic functions as part of a settlement or compromise of a claim or claims, then the rejection of such a settlement by the Court would necessarily interfere with the City's governmental powers and/or its property and revenues. *See* 11 U.S.C. § 904(1), (2).[4]

In sum, the suggestion by the Capital Markets Creditors that requiring the City to seek the Court's approval of the Hallon Settlement Agreement (and future settlements) will have no impact on the City's property and revenues is baseless. Such a requirement will impact the City both by forcing the City to litigate the settlement itself (and, potentially, the underlying claims) and by allowing the Court to reject the City's decisions on fundamental governmental processes. These are precisely the interests that section 904 protects from court interference.

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[4] Another example of this, as described above, would be a settlement wherein the City renegotiated any of its labor contracts. Such settlements would lie at the heart of the City's governing powers, and subjecting such agreements to the Court's approval would clearly put the Court in the position of making government decisions for the City, which is the very situation section 904 seeks to avoid.

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III. CONCLUSION

For the reasons set forth above, the City respectfully requests that the Court rule that it is not required to seek the Court's approval of the Hallon Settlement Agreement (or alternatively, approving the settlement) and granting such other and further relief as the Court deems appropriate under the circumstances.

Dated: November 13, 2012

ORRICK, HERRINGTON & SUTCLIFFE LLP

By: *__/s/ Marc A. Levinson__*

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