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22 UNITED STATES BANKRUPTCY COURT
23 EASTERN DISTRICT OF CALIFORNIA
24 SACRAMENTO DIVISION

25 In re:) Case No. 12-32118
26)
27 CITY OF STOCKTON, CALIFORNIA,) DC No. OHS-1
28)
29 Debtor,) Chapter 9
30)
31)
32) Date: February 26, 2013
33) Time: 1:30 p.m.
34) Dept.: C, Courtroom 35
35) Judge: Hon. Christopher M. Klein

36 **SUPPLEMENTAL OBJECTION OF ASSURED GUARANTY CORP.
37 AND ASSURED GUARANTY MUNICIPAL CORP. TO DEBTOR'S
38 CHAPTER 9 PETITION AND STATEMENT OF QUALIFICATIONS**

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1 Assured Guaranty Corp. and Assured Guaranty Municipal Corp. (collectively, “Assured”)¹
2 hereby file this supplemental objection (the “Supplemental 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 evidence at trial will show
5 that the City cannot carry its burden of demonstrating it is eligible to be a debtor in this proceeding.
6 In particular, Assured submits that the City will be unable to establish that it (i) is insolvent under
7 11 U.S.C. § 109(c)(3); (ii) has satisfied the negotiation requirement contained in 11 U.S.C.
8 § 109(c)(5); (iii) has negotiated in “good faith” under Cal. Gov’t Code § 53760.3(o), which is a
9 requirement for specific authority under Cal. Gov’t Code § 53760(a) to be a debtor under 11 U.S.C.
10 § 109(c)(2); and (iv) has filed its petition in “good faith” under 11 U.S.C. § 921(c).

11 This Supplemental 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 developed
13 during discovery, and four (4) expert reports filed contemporaneously herewith.² The Report of
14 Nancy T. Zielke of Alvarez & Marsal (the “Zielke Report”) demonstrates that (i) Stockton can
15 achieve various budget efficiencies that, when combined with revenue enhancements, would allow
16 the City to remain viable and cash flow solvent outside of bankruptcy and (ii) Stockton’s financial
17 reporting remains seriously flawed and inherently unreliable. The Report of Robert C. Bobb of
18 The Robert Bobb Group (the “Bobb Report”) addresses the City’s poor operational decisions in
19 response to the City’s financial distress and demonstrates that the City could have and should have
20 instituted certain cost-cutting and revenue-generating activities prior to seeking relief in Chapter 9.
21 The Reports of Joseph Brann (the “Brann Report”) and Professor David Neumark (the “Neumark
22 Report”),³ among other things, rebut the City’s stated position that any effort to modify the existing

23 ¹ Capitalized terms not otherwise defined herein have the same meanings ascribed to such terms in
24 the Preliminary Objection of Assured Guaranty Corp. and Assured Guaranty Municipal Corp. to
25 Debtor’s Chapter 9 Petition and Statement of Qualifications (the “Preliminary Objection”) [D.I.
26 482].

27 ² Copies of the materials cited herein and in the expert reports will be provided to the Court, the
28 Debtor, and any other parties objecting to the Debtor’s bankruptcy petition in advance of the
scheduled pre-trial conference.

³ The Neumark Report is being filed by National Public Finance Guarantee Corporation (“NPFG”).

1 pension benefits under or outside of the CalPERS system would result in a mass exodus of police
2 officers or would adversely impact public safety or Stockton's crime rate.

3 For the reasons discussed below and in the expert reports, and because the City has not
4 carried its burden that it has satisfied the requirements for eligibility under Chapter 9, Assured
5 respectfully requests that the Court deny the City's Chapter 9 petition, dismiss this bankruptcy
6 case, and grant such other further relief as the Court may deem proper.

7 **I. PRELIMINARY STATEMENT**

8 In his February 2012 update to the City Council, Stockton's City Manager made one point
9 very clear: "Our employees and the citizens of Stockton who receive city services have borne the
10 entire brunt of our restructuring efforts so far and now [it's] time for others to do the same." Ex. 68
11 at 251.3 (Report, R. Deis to Mayor and City Council, Fiscal Condition Update for Fiscal Years
12 2010-11, 2011-12 and 2012-13, Feb. 28, 2012 (emphasis in original)). This has been the City's
13 approach to its financial challenges and this Chapter 9 case. The agenda is clear – the City hopes
14 to use the Chapter 9 plan process to impose permanent impairment, and to cram down a non-
15 consensual plan, on capital market creditors in order to free up cash to fund above-market labor
16 and pension costs and non-essential services, while refusing to consider, much less implement,
17 additional sources of revenue and much-needed expenditure reductions. This is not a legitimate
18 use of Chapter 9, and the City should not be allowed to remain a debtor in this case.

19 Stockton has now reached short-term labor agreements with each of its ten (10) unions,
20 which are subject to renegotiation starting in 2013. Through these new labor agreements (which
21 enable labor to begin pressuring the City, once again, in just a matter of months), the City believes
22 it has eliminated some of the excessive benefits, above-market compensation and other promises
23 that the City made to its employees in past years, which the City acknowledges should never have
24 been made in the first instance. These agreements could and should have been secured outside of
25 bankruptcy and, in fact, nine (9) were inked shortly after the City filed its bankruptcy petition.

26 Yet, those agreements do not go nearly far enough. The City is seeking to leave intact and
27 untouched all promised pension benefits and its obligations to CalPERS, the costs of which are
28 projected to increase by 94% over the next 10 years. Ex. 50 at 9 (CITY OF STOCKTON'S PROPOSALS

1 FOR MODIFICATIONS TO OBLIGATIONS UNDER AB 506 PROCESS (May 7, 2012)) (the “Ask”). In
2 other words, the City declines to use Chapter 9 to address its single largest liability – unfunded
3 pension costs – or to seek relief or concessions from CalPERS to fix its pension funding problem.

4 That leaves the Capital Market Creditors,⁴ which the City has targeted since the outset, and
5 with whom it refused to negotiate.

6 As the City Manager’s comments indicate, the City has every desire to fund its
7 restructuring on the backs of those from whom it previously borrowed hundreds of millions of
8 dollars. Rather than engaging the Capital Market Creditors in a constructive dialogue and taking
9 every step it could to avoid filing for bankruptcy, the City, through its own inaction and indecision,
10 budgeted itself into insolvency, hoping that it could cram down a plan on those it did not favor.
11 See Ex. 238 at A7-A8 (CITY OF STOCKTON 2012-2013 PROPOSED ANNUAL BUDGET (May 12,
12 2012)) (refusing to make any cuts in light of budget shortfall).

13 Although the City points to its alleged insolvency as a basis for its approach to, and
14 proposed treatment of, the Capital Market Creditors, the City had, and continues to have, multiple
15 options to allow it to address its financial challenges outside of bankruptcy. As explained below,
16 the City could have modified medical benefits for retirees (described by the City as the
17 “Lamborghini” plan) outside of bankruptcy, as it has done in the past, in a manner that would make
18 them affordable for the City and would provide medical benefit options for retirees. The City also
19 failed to propose any tax or fee increases – or even poll its citizens on the topic of revenue raises –
20 prior to filing. Rather, the City Manager advised the City Council that “[e]ven if the voters would
21 approve such a proposal, we just don’t think they should be asked to fix this problem, at least until
22 we explore other alternatives, address our liquidation exposure and get our house in order.” Ex. 68
23 at 251.3. The City even failed to seek a hardship exemption from CalPERS – which could have
24 reduced its payments in the current fiscal year by approximately \$1.25 million. This involved an
25 application, not a negotiation. Indeed, the City waited until December 4, 2012 – five months into

26 _____
27 ⁴ “Capital Markets Creditors” refers to the following entities: (i) Assured, (ii) NPMFG, (iii) Franklin
28 High Yield Tax Free Income Fund and Franklin California High Yield Municipal Fund, and (iv)
Wells Fargo Bank, National Association, in its capacity as indenture trustee.

1 bankruptcy – to request such an exemption. This was no oversight. Discovery has revealed that
2 the City evaluated its “business case for remaining current and in good standing with CalPERS”
3 only *after* it knew the Capital Market Creditors would be objecting to eligibility. The City’s case
4 for its “hands off CalPERS” approach is nothing but pretext and after-the-fact justification
5 attempting to obscure the City’s true politically-driven motivation of protecting labor. The
6 evidence shows that the City only began to take a hard look at its eligibility for Chapter 9 *after* it
7 filed for bankruptcy, including seeking to value non-essential assets for sale purposes and polling
8 its citizens on revenue enhancement measures, and that the City left millions of dollars on the table
9 in terms of additional budget efficiencies and revenue enhancements that could be achieved outside
10 of bankruptcy without jeopardizing public safety.

11 Further, the City’s own financial information cannot be trusted to demonstrate insolvency.
12 Its long-delayed Comprehensive Annual Financial Report for the 2010-11 fiscal year (“FY 2010-11
13 CAFR”) reports nearly forty (40) material weaknesses and significant deficiencies. And although
14 the City had initially claimed it needed to file for bankruptcy in late June because it would be out
15 of money in early July, the City now reports both that it beat its projections for the fiscal year
16 ending June 2012 by *over \$6 million* and that its estimates were off on approximately ten (10)
17 principal categories of revenues and expenses. The City just does not have a reliable handle on
18 either its current finances or its future finances, continues to fund unneeded programs and services,
19 and has refused to explore sources of available revenue and revenue enhancement measures
20 through all relevant periods. The City thus cannot provide sufficient, persuasive and credible
21 evidence of insolvency.

22 The facts show that the City also failed to negotiate in good faith with its creditors.
23 Throughout the required mediation under AB 506 (the “AB 506 Process”), the City told the Capital
24 Market Creditors to “trust us – we’re insolvent and there is nothing more that can be done to repay
25 your debt.” Assured’s efforts to negotiate off the “take-it-or-leave-it” offer contained in the Ask
26 were met with the City’s refusal to negotiate and with statements by the City that it had offered all
27 it could afford, based upon 10 year projections the City cobbled together without the benefit of a
28 completed CAFR for 2011 (even though that fiscal year had ended nearly a year before) and

1 without reliable financial controls. Indeed, the financial information the City released last week
2 confirms that the City's statements about its fiscal position cannot be trusted, nor can its financial
3 projections.

4 Although the City has targeted the Capital Market Creditors in its Chapter 9 case, they did
5 not cause the City's financial predicament. To the contrary, the Capital Markets Creditors
6 extended or made it possible for the City to obtain market-rate loans on market-based terms. In
7 contrast, the City has admitted that, for many years, it provided unsustainable and above-market
8 wages and benefits to employees. The City's recent, short-term deals with labor do nothing to
9 brighten the City's long-term prospects, because the City refuses to tackle its most serious
10 economic issue – rising pension costs under the CalPERS system. Stockton wants to double down
11 on the CalPERS system, despite acknowledging a pension obligation that would leave the City
12 nearly \$100 million dollars in the hole over the next ten years under its own (unreliable)
13 projections.

14 The City has tried to excuse its approach by claiming that it cannot jeopardize its
15 relationship with CalPERS if it wants to attract employees, specifically police officers. Yet
16 Stockton has hired over 70 police officers this year alone, and “unprecedented numbers” of
17 applicants – 1,300 – arrived just this week at a recruiting event for Stockton's police department.⁵

18 The consequences of Stockton's “hands off” approach to its CalPERS obligations could be
19 severe. As of June 30, 2011, CalPERS estimated the aggregate actuarial value of the City's
20 unfunded pension liability at \$172 million. See Ex. 422 at 6 (CalPERS Annual Valuation Report
21 of the Miscellaneous Plan of the City of Stockton (as of June 30, 2011)) (listing the actuarial value
22 of the unfunded liability for Stockton's Miscellaneous Plan at \$54.9 million); Ex. 423 at 6
23 (CalPERS Annual Valuation Report of the Safety Plan of the City of Stockton (as of June 30,
24 2011)) (listing the actuarial value of the unfunded liability for Stockton's Safety Plan at \$117
25 million). On a market value basis, CalPERS estimates the unfunded liability for both plans at

26 ⁵ *Record Number of Stockton Police Hopefuls*, THE RECORD, Dec. 13, 2012,
27 http://www.recordnet.com/apps/pbcs.dll/article?AID=/20121213/A_NEWS/212130322 (quoting
28 Stockton Police Department spokesman, Joe Silva).

1 \$322.5 million. Ex. 422 at 6; Ex. 423 at 6. Should the City be unable to satisfy its monumental
2 CalPERS liability and thereby need to withdraw from the CalPERS system in the future – outside
3 of bankruptcy – it could face a draconian termination liability (the unfunded portion of which
4 CalPERS valued as of June 30, 2011 at \$946 million) and a lien on all of its assets. See Ex. 422 at
5 15 (unfunded termination liability for Miscellaneous Plan would be \$357.7 million); Ex. 423 at 15
6 (unfunded termination liability for Safety Plan would be \$588.4 million).

7 Unless the City is willing to tackle its pension liabilities and obligations to CalPERS, there
8 is no legitimate purpose served by permitting it to remain in Chapter 9.

9 Trying to cram down a plan of adjustment on the funded debt will not fix the City's long-
10 term financial problems and will only hinder the City's ability in the future to access the capital
11 markets for improvements to the City's critical infrastructure. Moreover, Stockton's refusal to
12 negotiate over its largest claim or to explore any pension alternatives – while seeking to
13 substantially reduce payments to the Capital Market Creditors – prevents the City from showing it
14 negotiated with creditors in good faith under the Bankruptcy Code or AB 506.

15 The law is clear. Chapter 9 is not a resort – it is the last resort. A municipality cannot
16 budget itself into insolvency to gain access to Chapter 9 or use Chapter 9 to harass or target certain
17 groups of creditors. Stockton has done both. Stockton did not need to file for bankruptcy in order
18 to stay in the same broken CalPERS system and apply the same faulty budget principles that
19 created its financial hardship in the first instance. If the City wants to bear the heavy weight of its
20 CalPERS burden, its citizens should be required to fund that decision, not Assured or the other
21 Capital Market Creditors. Upon dismissal, the City can and should pursue the revenue
22 enhancements identified in the Zielke Report, implement the cost-savings measures listed in the
23 Zielke and Bobb Reports, negotiate with its unions acceptable modifications to the retiree medical
24 plan, and actually come to the table with the Capital Market Creditors to discuss reasonable terms
25 for the repayment of the City's debt. It should be required to do so.

26 **II. ARGUMENT**

27 A municipal debtor bears the burden of establishing it is eligible for relief under Chapter 9.
28 See, e.g., In re City of Stockton, 475 B.R. 720, 725-26 (Bankr. E.D. Cal. 2012) (citing cases); In re

1 Sullivan County Regional Refuse Disposal Dist., 165 B.R. 60, 72 (Bankr. D.N.H. 1994) (“Sullivan
2 County”). “[A]ccess to chapter 9 relief has been designed to be an intentionally difficult task.” Id.
3 at 82; see also In re Cottonwood Water and Sanitation Dist., 138 B.R. 973, 979 (Bankr. D. Colo.
4 1992) (“Congress consciously sought ‘to limit accessibility to the bankruptcy court’ by
5 municipalities.”). As a result, “[t]he bankruptcy court’s jurisdiction should not be exercised lightly
6 in chapter 9 cases.” Sullivan County, 165 B.R. at 82. As demonstrated below, the City has failed
7 to carry its burden on multiple eligibility requirements.

8 **A. Stockton Has Not Demonstrated Cash Flow Insolvency.**

9 In order to carry its burden on insolvency, the City must prove either that it is “(i) generally
10 not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or
11 (ii) unable to pay its debts as they become due.” 11 U.S.C. § 101(32)(C). Solvency is measured as
12 of the petition date. See, e.g., In re Town of Westlake, 211 B.R. 860, 864 (Bankr. N.D. Tex. 1997)
13 (citing cases).

14 The purposeful refusal to make a few payments comprising a relatively small part of the
15 City’s budget does not satisfy the definition of “insolvent” under 11 U.S.C. § 101(32)(C)(i). See,
16 e.g., Uecker & Assocs. v. Tenet Healthsystem Hosps., Inc. (In re West Contra Costa Healthcare
17 Dist.), No. 06-41774 T, 2010 Bankr. LEXIS 994, at *8 (Bankr. N.D. Cal. Mar. 26, 2010) (failure to
18 pay \$1.3 million out of \$10-\$11 million total operating expenses did not mean the debtor was
19 “generally not paying its debts”). The City has not demonstrated it was unable to pay its debts as
20 they came due as of the Petition Date under 11 U.S.C. § 101(32)(C)(ii) for two independent
21 reasons.

22 First, the City “deliberately budget[ed and] spen[t] itself into insolvency (so as to qualify
23 under § 101(32)(C)(ii)), when other realistic avenues and scenarios [were] possible.” Town of
24 Westlake, 211 B.R. at 867.

25 Second, “[t]he mere fact that a municipality has adopted a budget that reflects a cash flow
26 shortfall is not independently sufficient to meet the requirement of the ‘unable to pay’ test.”
27 COLLIER ON BANKRUPTCY ¶ 900.02[2][c][i] (16th ed. 2011). Such a budget “must be evaluated in
28 light of past and current practices, the practices of similar municipalities, and the extant facts and

1 circumstances.” Id. Here, Stockton’s past and current practices, as well as extant facts and
2 circumstances, not only show that the City has many available (but unexplored) options to enable it
3 to pay its debts as they become due, but also that the City simply has no reliable handle on its own
4 finances. Thus, the information provided in the City’s current budget is “insufficient credible
5 proof” of insolvency. Town of Westlake, 211 B.R. at 867; see also In re City of Bridgeport, 129
6 B.R. 332, 338 (Bankr. D. Conn. 1991) (requiring concrete proof “that [the city] will be unable to
7 pay its debts as they become due in its current fiscal year or, based on an adopted budget, in its
8 next fiscal year” and noting that “[o]bviously, it is necessary for cities to make informed financial
9 projections”). The City’s poor grasp of its own finances not only calls into question the City’s case
10 on insolvency, it also illustrates why the City cannot carry its burden on negotiation or good faith.

11 **1. Stockton Has Budgeted Itself Into Insolvency.**

12 Section 109(c)(3) of the Bankruptcy Code requires that, before a city can demonstrate
13 insolvency, city leaders must first behave with the necessary financial discipline and must first
14 attempt to solve problems by making hard choices to cut services or raise fees. See, e.g., Town of
15 Westlake, 211 B.R. at 867 For example, the Bridgeport court concluded that a city’s budget gap
16 and extraordinary financial difficulties – including a police force substantially below the minimum
17 the chief felt necessary to provide basic, adequate service levels – did not satisfy the requirement of
18 “insolvency” for Chapter 9. See 129 B.R. at 335-36. The Bridgeport court dismissed the petition
19 because, although Bridgeport was in “deep financial trouble” and might soon become “insolvent,”
20 it failed to satisfy the Bankruptcy Code definition of “insolvent.” Id. at 339. Like Bridgeport,
21 Stockton may be able to show that it is in “deep financial trouble” and may need to seek
22 bankruptcy protection in the future. However, it cannot be a Chapter 9 debtor now unless it can
23 prove with detailed and reliable financial information that it could not access the cash needed to
24 meet its enforceable payment obligations in the current fiscal year. See id. at 338 (“[A] city must
25 prove that it will be unable to pay its debts as they become due in its current fiscal year or, based
26 on an adopted budget, in its next fiscal year.”). The facts show that the City cannot carry that
27 burden.

28 For example, the Zielke Report identifies over \$24 million in cost-cutting measures the City

1 could have implemented in its FY 2012-13 Budget and over \$9.5 million in combined revenue-
 2 generating activities Stockton could have and should have pursued. Zielke Report at 6, 45. Even
 3 without Stockton’s unexpected \$6 million surplus, the availability of these options to create a
 4 budget surplus undermines any evidence Stockton might submit to show insolvency as of the
 5 Petition Date.

6 a. Stockton Continues Its Practice Of Voluntary, Excessive Spending.

7 The City has failed to undertake the politically-unpopular work of distinguishing between
 8 “essential” and “non-essential” expenses and separating mandated services from non-mandated
 9 services. The City maintains that every dollar called for in its recent budgets has been required for
 10 “essential” or mandated services – that not a single dollar could be spared without either violating a
 11 legal obligation of the City or jeopardizing the health, safety, or welfare of its citizens. See Deis
 12 Dep. 65:13-21, Nov. 28, 2012. The evidence is to the contrary. Even though the City knew that its
 13 finances were out of control no later than 2010, the City has taken the politically-expedient course
 14 of continuing popular, but patently non-essential, expenses, see id. 62:3-15, 64:25-65:14, and has
 15 continued to pay above-market wages and benefits in fiscal year (“FY”) 2011-12.

16 Even a cursory review of the City’s current budget reveals that Stockton has maintained its
 17 fiscally irresponsible spending practices. Although somewhat leaner than in years past, the City’s
 18 continued spending decisions do not reflect an organization committed to making the difficult
 19 choices needed to address its financial distress. Rather, Stockton’s budget illustrates that the City
 20 intends to maintain at least its existing level of services by using funds otherwise payable to certain
 21 targeted creditors. Like the Town of Westlake, Stockton should be denied access to Chapter 9 until
 22 it implements necessary cost-cutting activities. See Town of Westlake, 211 B.R. at 867
 23 (dismissing Chapter 9 petition because the debtor had not first explored “refiguring road
 24 expenses . . . , negotiating with attorneys about fee contracts, approaching developers, seeking
 25 business relocations, conserving and maximizing remaining ample funds, etc.”).

26 i. The “Nice To Haves” v. The “Must Haves”

27 The manager of a city in crisis must distinguish between what Mr. Bobb calls the “Must
 28 Haves” and the “Nice to Haves.” See Bobb Report at 19-22. That is, there are core services a city

1 must fund (the “Must Haves”), and there are other functions that may provide public benefits, but
2 which must be cut if no longer affordable (the “Nice to Haves”). Stockton’s City Manager has not
3 drawn a distinction. The City’s continued subsidies of its entertainment venues are prime
4 examples of the City’s failure to cut non-essential spending in FY 2011-2012 and FY 2012-2013.
5 For example, the City budgeted \$2.4 million in FY 2011-2012 to subsidize its entertainment
6 venues. Ex. 238 at D3. And in its FY 2012-2013 budget, Stockton transferred \$575,000 from the
7 General Fund to the General Capital Improvements Fund to address the City’s infrastructure needs.
8 Ex. 27 at 163-64 (Report, R. Deis to Mayor and City Council, Staff Report and Recommendations
9 for Adopting Proposed Fiscal Year 2012-2013 Budget, June 26, 2012); Report, D. Millican to
10 Mayor and City Council, Budget Amendment and Fiscal Conditions Update for Fiscal Year 2012-
11 13, Sept. 11, 2012, at Ex. 1 (“Sept. 2012 Budget Update”). One asset specifically selected to
12 receive a portion of these funds was a recreational facility. Ex. 238 at A6; Deis Dep. 82:24-83:17
13 (recounting funding recommendation).

14 The City’s funding of non-essential assets does not begin and end with a single recreational
15 facility. In December 2012, the City decided to increase its budgeted subsidies for entertainment
16 venues and certain other recreational facilities by up to \$310,000 for the year, in addition to the
17 over \$2 million budgeted for those purposes as of September 2012. Compare Sept. 2012 Budget
18 Update at Ex. 1 with Report, V. Burke to Mayor and City Council, General Fund Results and
19 Update for Fiscal Years 2011-12 and 2012-13, Dec. 11, 2012, at 701 (“Dec. 2012 Budget
20 Update”).

21 Other non-essential services also receive considerable funding. The City funds library
22 services to the tune of almost \$4 million. Sept. 2012 Budget Update at Ex. 1. More than \$2.5
23 million is budgeted to the Recreation Fund. Id. Both of these services were not only deemed
24 “essential” as a matter of policy, but so crucial that they require nearly \$6.5 million worth of
25 General Fund support, in addition to the \$1,000,000 the City also approved to reorganize and
26 restructure the Community Development Department. Ex. 238 at A6; Deis Dep. 83:22-84:1.
27 Although the City might point to the elimination of the arts endowment fund as evidence of cutting
28 non-essential programs, see Deis Dep. 106:4-7, it appears that the City continues to treat that

1 money as a specially-designated subfund within the General Fund, to be used only for arts, see FY
2 2010-11 CAFR at 676. Thus, even the City's proclaimed "cuts" to non-essential programs cannot
3 be relied upon as effectively changing its funding decisions.

4 ii. The City Has Not "Exhausted All Options" To Cut Expenses.

5 In January 2012, having projected a General Fund deficit for FY 2012-13, the City's Chief
6 Financial Officer ("CFO") directed each department head to propose the specific cuts needed to
7 reduce that department's General Fund costs by "target reduction levels" of 5, 10, and 15%. Mem.,
8 S. Mayer to Dept. Heads and Dept. Budget Analysts, FY 2012-13 General Fund Targets and
9 Budget Instructions, Jan. 18, 2012. This review afforded Stockton's leadership an inventory of
10 available reductions within each City department and explained the effect of each proposed cut on
11 City services. Ex. 68 at 251.40-251.52. And while they presented difficult choices, these
12 recommendations gave Stockton's leaders a foundation for arriving at a balanced budget this year.
13 Stunningly, Stockton's City Manager recommended that the City Council reject every cut
14 identified by the department heads. See Deis Dep. 90:3-16; Ex. 68 at 251.26-27. The City Council
15 obliged, and, outside a "very small" reduction of the Public Works budget, see Deis Dep. 97:16-18,
16 adopted a budget that captured none of the proposed reductions, see Ex. 238. This approach left
17 the City with no options except mediation under AB 506.

18 In his contemporaneous report to the City Council, made on the eve of embarking on the
19 AB 506 Process, the City Manager made the point very clearly: "Our employees and the citizens of
20 Stockton who receive city services have borne the entire brunt of our restructuring efforts so far
21 and now its [sic] time for others to do the same." Ex. 68 at 251.3 (emphasis in original). In fact,
22 his remarks in the lead-up to bankruptcy illustrate why the City ultimately failed to make any hard
23 decisions: "the Council has expressed no interest in going here, [and] *I am not going to put the*
24 *organization through the process of cutting an extra \$3.2 million.*" Ex. 238 at A7-A8 (emphasis
25 added). These statements are not the hallmark of a City leader who views bankruptcy as the "last
26 resort." They do, however, explain why the budget reduction scenarios studied in January and
27 February 2012 – and rejected by the City Council in June – never addressed the City's total
28 projected shortfall for FY 2012-13 or forced the City to consider how it could reach a level budget

1 for FY 2012-13. As bankruptcy was predetermined, they did not need to.

2 The City cannot credibly say that not one of the reductions proposed in February 2012
3 could be implemented. As described above, Stockton has not distinguished, in any systematic way,
4 its essential and non-essential services. The City has not eliminated funding of entertainment
5 venues and recreational facilities at a time of fiscal distress; it has increased non-essential budgets.
6 Id. at D3. Nor did the City realize savings by eliminating vacant positions or explore any number
7 of other cost-cutting measures that would save it nearly \$8.9 million in the first year alone. See,
8 e.g., Zielke Report at 49. It just did not want to make the effort.

9 iii. Stockton Continues To Provide Excessive Wages And Benefits.

10 As the City wrestled with budget shortfalls in 2010 and 2011, it was forced to acknowledge
11 that principal among its many spending excesses were the unsustainable wages and benefits
12 provided to its labor force. Ex. 62 at 1 (Action Plan For Fiscal Sustainability, June 22, 2010)
13 (noting “immediate and long term challenges caused in part by escalating and unfunded costs in its
14 labor agreements”). In fact, the City estimates that historical wages were inflated by more than
15 25%. See, e.g., Ex. 410 at 1 (Katherine Miller, Transcript of Video Presentation re: Stockton
16 Bankruptcy).

17 Stockton has since made some strides to reduce or eliminate certain problematic
18 compensation practices, and the City has tried to reposition itself near the median of its (hand-
19 picked) “comparable” labor market. Deis Dep. 251:11. However, Stockton has not addressed the
20 structural causes of its persistent budget problems – the “overly generous wages and benefits . . .
21 [that] are the most significant financial problems facing the City.” See Bobb Report at 26. Indeed,
22 in a recent round of negotiations with labor, the City freely admits that it agreed to “things that are
23 above the labor market average” in order to reach agreements. Ask at 25; see also Deis Dep.
24 183:13-14 (estimating the value of that concession at \$3 million). Nor has the City adequately
25 addressed long-term pension benefit costs, which are expected to increase by 94% over ten years.
26 See Ask at 9.

27 The City’s basic approach to setting compensation also remains fundamentally flawed,
28 because it continues to use an unjustified “comparable city” approach that does nothing but drive

1 labor costs higher without any quantifiable benefit in terms of employee retention or recruitment.
2 Stockton continues to commit to paying each category of employee “competitive” wages that are
3 completely unmoored from (i) the City’s ability to pay, see Miller Dep. 44:1-46:6, Nov. 9, 2012;
4 (ii) its tax base, Deis Dep. 167:17-168:11; (iii) the skills needed to fulfill a particular position; (iv)
5 the demand for particular skills in the marketplace; and (v) the actual total cost of the employee to
6 the City, Deis Dep. 160:11-12, 164:21-165:24. Rather than implementing viable, but politically
7 unpopular, long-term structural reform, the City Council continues to put band-aids on a much
8 larger problem involving its cost of labor.

9 (a) The City Admits That The Wages And Benefits It Has
10 Now Cut Were “Luxurious” And “Extreme.”

11 The City has made very clear that its past compensation practices were unsustainable. First,
12 the retiree medical insurance program, described by Vice Mayor and Councilmember Kathy Miller
13 as a “Lamborghini plan,” Ex. 410 at 1, was “if not the most generous, one of the most generous in
14 the state,” Deis Dep. 129:17-18. It conferred “luxurious” benefits that were unlike anything
15 available to average Stockton residents: *“This was free medical care for a retiree and a dependent
16 for [the] rest of their lives. No co-pays, no generic requirements, no HMOs, and no premiums. See
17 any doctor, stay in any hospital, purchase any drug, and just send the bill to the City of Stockton.”*
18 Ex. 410 at 1 (emphasis added).

19 Second, the wage and benefit packages were determined by salary comparisons with other
20 cities that had “marginal relevance” to Stockton, see Deis Dep. 161:24-162:2; see also Ex. 64 at
21 158 (Report, R. Deis to Mayor and City Council, Emergency Measures for Fiscal Year 2011-12,
22 May 17, 2011), or were based on “irrational comparisons” to the City, see Ex. 62 at 3; see also
23 Deis Dep. 161:11-164:1.

24 Third, Stockton offered additional pay (“add-pay”) categories to safety employees that were
25 “extreme and not supportable in the labor market,” Deis Dep. 157:3-4; 158:11-24, and were
26 available for “almost everything imaginable,” Ex. 410 at 1. For instance, “If you drove the front of
27 a fire truck, if you drove the back of a fire truck, if you got a degree or certificate, even if it was for
28 something that had nothing to do with your job. And longevity pay was granted that began after

1 only three years on the job. Gradually, *these ad[d]-pays resulted in some of our employees earning*
 2 *more than 25% over the statewide job market.” Id.* (emphasis added).

3 Finally, the City offered overly rich pension benefits and early retirement to its employees,
 4 with some retirees riding off into the sunset at fifty years old with 90% to 100% of their highest
 5 year’s pay for the rest of their lives, plus a 5% annual cost-of-living adjustment. See id. Vacation
 6 and sick time that were available to be “cashed out” without limit, plentiful overtime, and lucrative
 7 add-pays enabled Stockton government employees to realize enormous salaries and “make . . .
 8 pension spiking into an art form, using overtime and add-pays in their final working years to secure
 9 much larger pensions for the rest of their lives.” Id. It was from this inflated status quo that the
 10 City approached labor for “concessions.”

11 (b) The City’s Deals Only Reduce A Windfall To Employees.

12 Although the City claims it has cut the excessive benefits out of its most recent labor
 13 agreements, the City has made no cuts to the base wages of any City employee. It merely stopped
 14 giving above-market “add-pay” and “premium pay” to its public safety employees in an effort to
 15 return Stockton employee compensation levels to alleged market levels. These “deep cuts to
 16 employee compensation and benefits in recent years . . . have left Stockton, for the most part, at the
 17 labor market average.” Ex. 109 at 3 (Letter, R. Deis to Hon. Jerry Brown et al., Reform of Public
 18 Pension Law and Practices, Aug. 15, 2012). That is, Stockton city employees – *over 150 of whom*
 19 *have received \$200,000 or more in annual compensation in recent years, see Zielke Report at 18-*
 20 *19* – have “borne the entire brunt” of being returned to somewhere near the alleged market average
 21 for salary and benefits. In scrapping the “luxurious” benefits of the “Lamborghini” health plan, in
 22 eliminating overly generous add-pays that were “extreme,” in preventing certain means of abusing
 23 the pension system via “spiking,” the City has simply returned compensation to more appropriate
 24 levels.⁶ What the affected Stockton employee, therefore, has “given up” (at least temporarily) is a

25 ⁶ Accord Deis Dep. 250:18-251:1 (Q: “[I]t would seem, Mr. Deis, that what the current employees
 26 have done is receive years of above-market pay and what they are now doing is now being dropped
 27 down to the labor market average, or for the most part the labor market average; isn’t that a fair
 28 statement? . . . A: For the most part.”); Miller Dep. 97:8-20 (Q: “[W]hat you’ve done is you’ve
 reduced the compensation to what you understand to be the appropriate marketplace, correct? A:
 Yes. Q: So prior to that time, the employees of the City . . . including the safety employees, had

1 continued inflation of pay. That employee gets to keep his unearned windfalls paid in the past.
 2 And because the City refuses to negotiate with CalPERS, the City has made no effort to clawback
 3 the pension windfall that was awarded to its retirees.

4 (c) The City Uses The Same Flawed “Comparable City”

5 Analysis That Led To Its “Unsustainable” Compensation.

6 Although its compensation practices have improved, the City still cannot establish that it
 7 can maintain its current compensation structure over the long-term. To the contrary, even though
 8 no longer baked into its collective bargaining agreements, the City continues to embrace the
 9 “comparable city” analysis that led directly to its unsustainable wage structure in recent years.

10 The City has reiterated time and again its goal to “remain in the middle of the job market
 11 for comparable cities.” See, e.g., Miller Dep. 47:8-9. However, many of these so-called
 12 comparable cities are hundreds of miles away and have no clear connection to Stockton’s
 13 employment market.⁷ For example, Chula Vista, a city approximately 465 miles south of Stockton
 14 near the Mexican border, is used by Stockton as a comparable city. Neither the City Manager nor
 15 its HR Director could provide any evidence that Stockton is competing with Chula Vista or any
 16 other “comparable city” in recruiting new employees or retaining its existing employees. See Deis
 17 Dep. 174:24-175:20; Haase Dep. 45:11-24, Nov. 14, 2012. As described by Mr. Bobb, the
 18 comparable city approach is inappropriate for most non-safety jobs, with the exception of
 19 department heads and other specialized positions, and should be abandoned. See Bobb Report at
 20 29.

21 More importantly, using comparable cities as the basis for employee compensation in
 22 Stockton works to disconnect the City’s decision-making from market wages in Stockton – and
 23 from what Stockton can *afford* to pay. As described in the Bobb Report at pages 26-27, the

24
 25 been receiving for some period of time above-market compensation, correct? . . . A: In my
 understanding, yeah.”)

26 ⁷ For example, the Ask provides several “comparable cities” that are hundreds of miles away from
 27 Stockton. See Ask at 37 (including as comparable cities Salinas [131 miles from Stockton],
 Bakersfield [233 miles], Riverside [388 miles], Fresno [127 miles] Chula Vista [465 miles], San
 Bernardino [386 miles]).

1 comparable city method allows a union that secures a concession for its members in one
2 jurisdiction to exact a similar concession from other cities seeking to remain “competitive.” With
3 frequent contract negotiations between unions and local jurisdictions, and through the use of the
4 “salary comparison” mechanism, the concessions approved in one jurisdiction are adopted by other
5 jurisdictions, which causes a perpetual “ratcheting up” phenomenon of ever-increasing
6 compensation. Neumark Report at 21. The City is in no position to compete in the “comparable
7 cities” arms race that is largely responsible for its current fiscal predicament. Indeed, the City’s
8 commitment to maintaining unsustainable labor practices illustrates that it has not yet been willing
9 to seek the labor concessions it needs on a long-term basis. The City cannot claim it has cut-to-the
10 bone based on temporary cuts that were only ever intended to make its compensation average (at
11 best) when compared to a set of “comparable cities” that often bear little or no relationship to
12 Stockton geographically, demographically, or financially.

13 iv. The City Has Not Explored Privatization, Shared Services Or
14 Consolidation.

15 Numerous opportunities for cost savings by outsourcing, consolidating, or sharing services
16 are also available across City departments, but the City has failed to take advantage of many of
17 them. For example, the City has not exploited opportunities to share or consolidate services with
18 the surrounding county governments, school districts, or other public or private entities. Bobb
19 Report at 24. Opportunities to improve efficiencies, including consolidating the police and fire
20 departments into a single public safety department or instituting a four-day work week for non-
21 safety personnel, were never considered. See Deis Dep. 52:6-12; Jones Dep. 73:13-14, Nov. 7,
22 2012. One idea that has showed promise elsewhere – merging a city’s police department with that
23 of the surrounding county⁸ – was rejected all too quickly in Stockton. See Bobb Report at 25-26.
24 The City has not attempted other means of reducing costs by privatizing functions such as code
25 enforcement, building inspections, building maintenance, and grants management – all services

26
27 ⁸ See Ex. 384 (Kate Zernike, *To Fight Crime, a Poor City Will Trade In Its Police*, N.Y. TIMES,
28 Sept. 28, 2012).

1 that can be done less expensively through contracting with private sector companies. See id. at 24.
2 Indeed, the City has for years sat on millions in unpaid parking tickets, see Ex. 105; collection of
3 these tickets could be turned over to a private collector. While forgoing these opportunities to date
4 has cost the City, they remain available to reduce expenses going forward.

5 v. The City Has Undertaken Other Unnecessary Obligations.

6 The City also made and continues to make bad decisions about what obligations to incur.
7 For example, in August 2011, the City volunteered to obligate itself as the successor agency to the
8 Stockton Redevelopment Agency (“RDA”). Other cities, recognizing the additional financial
9 burden associated with assuming such successor agency responsibilities, refused to do so and
10 allowed their respective counties to assume that role. But Stockton chose to obligate itself to
11 “absorbing the cost of RDA staff and having to pay former RDA obligations that lack sufficient tax
12 increment,” Ask at 8, despite its own acknowledged financial difficulties and the fact that the City
13 had already extended approximately \$81 million in advances to the RDA over the years, which it
14 ultimately had to write off its own balance sheet. See FY 2010-11 CAFR at 651. The City has
15 continued its trend of bad decision-making post-petition, including by seeking to settle and pay
16 disputed claims held by tort claimants and police outside the court’s review and without notice to
17 creditors. All of this is consistent with the City’s determination to make “others” bear the “brunt”
18 of the restructuring, but fundamentally inconsistent with the purpose and intent of Chapter 9 itself.

19 b. Stockton Has Failed To Maximize Its Revenues.

20 Even though it recognized years before seeking Chapter 9 relief that the City’s spending
21 was outpacing its revenues, Stockton has refused to act. Since 2010, the City has neither afforded
22 its citizens an opportunity to vote on new taxes, nor included discussion of a tax increase on the
23 City Council’s public agenda, nor sought to charge for various services currently being afforded to
24 its residents for free. And, in its sixth month of operating under its pendency plan, the City has not
25 yet completed an appraisal of what it deems “nonessential” real property. In short, the City
26 stubbornly refused to explore revenue-generating opportunities prior to requesting relief in
27 bankruptcy and cannot now use this failure to justify its eligibility for Chapter 9.

28

i. The City Has Not Sought To Increase Taxes.

The City commissioned a voter survey in 2010 on the topic of taxes and conducted a formal poll this year after filing for Chapter 9 relief – both showed that the City’s voters would support new tax measures. See Ex. 106 at 2 (Report, Fairbank, Maslin, Maullin, Metz & Assoc. to R. Deis, Summary of Key Survey Findings from 2012 Voter Survey, Sept. 26, 2012) (concluding that “[a] 3/4 cent sales tax measure remains viable, even if it is put forward while the City remains in bankruptcy”); see also Ex. 214 at 4-5 (Report, 2010 Open Poll re: Stockton Budget Priority). However, to date no initiative has been put before the City’s voters. Worse yet, no tax increase has even been *considered* as part of the City Council’s public agenda during that two-year period. Miller Dep. 24:8-27:22. Although a majority of voters supported a 1/4 cent sales tax increase in 2010 – and over two-thirds of Stockton voters surveyed in 2012 supported a larger, 1/2 cent increase⁹ – the City Manager actually recommended *against* any tax increase during the 2011-12 and 2012-13 fiscal years. Deis Dep. 129:21-130:2. A 1/2 cent sales tax increase alone could increase the City’s revenues by \$18 million on an annual basis. See Zielke Report at 36-37.

Early this year, at the time the City most needed to search for new ways to raise revenues, the City Manager dismissed the idea of recommending a somewhat modest sales tax increase (which, presumably, had the best prospect of voter approval) because “it wasn’t going to help out with that size of a deficit for [20]12/13 even if it did get passed.” Deis Dep. 126:2-3. Even with bankruptcy looming and citizens approaching him to raise taxes, id. 137:21-24, Mr. Deis claimed (without any supporting analytical or polling data) that “[w]e didn’t have a good position to sell the community,” id. 131:22-23. The City’s refusal to consider increasing taxes is entirely consistent with its intention of filing this case to eliminate funded debt: “[e]ven if the voters would approve such a proposal, we just don’t think they should be asked to fix this problem, at least until we explore other alternatives, address our liquidation exposure and get our house in order.” Ex. 68 at

⁹ Compare Ex. 214 at 4-5 (showing majority support for sales, users utility, and 911 emergency tax increases to maintain service levels and for employee pay and benefit cuts) with Ex. 411 at 4 (70% support for a measure to improve and maintain essential City services, including public safety, street repair, libraries and parks).

1 251.3.

2 The City also has declined to contemplate other tax increases. The City Council failed to
3 consider a possible increase in the City's user utility tax or the creation of a parcel tax. See Miller
4 Dep. 27:11-19; Deis Dep. 132:18-24, 142:6-10. Its transient occupancy tax rate – which has not
5 increased since 2009 – is over 20% lower than that of seven peer cities. See Zielke Report at 38.
6 Perhaps most importantly, the City did not explain to voters that an increase in an existing
7 dedicated tax or creation of a new dedicated tax could be directed to specific purposes, such as
8 improving public safety. See Deis Dep. 133:20-135:12. Instead, it actively discouraged citizens
9 who came forward to suggest increased taxes to improve or restore services, see id. 137:25-138:4,
10 and ignored polling results from 2010 that showed enough support to pass a measure dedicated
11 specifically to public safety, see Ex. 411 at 3 (Report, Fairbank, Maslin, Maullin, Metz & Assoc.,
12 Results of Fiscal Issues Survey, Sept. 16-18, 2012) (78% support for a 3/4 cent sales tax increase
13 dedicated only to public safety improvements).

14 Notably, the City's foot-dragging took place amid a groundswell of support within
15 California for local tax increases. The City wrongly assumed that the citizens of Stockton would
16 prefer bankruptcy to a sales tax increase and would not vote to raise revenue to stabilize the City's
17 financial condition. Although Stockton shied away from testing *any* ballot initiative in recent
18 years, 171 cities and counties in California passed tax and bond measures in last month's election
19 alone, including 80% percent of the general tax measures proposed.¹⁰ Stockton never gave its
20 citizens a chance to vote for a measure that would avoid bankruptcy by raising revenue, or for a tax
21 that would fund additional public safety or public improvements.

22 The City's failure to explore these options led in part to the state of financial affairs the City
23 used in June 2012 to justify its bankruptcy petition. As the Zielke Report demonstrates, a
24 combination of a 1/2 cent sales tax increase, 2% user utility tax increase, \$48 parcel tax, and 2%
25 transient occupancy tax increase, if passed, could have increased the City's annual revenues by

26 ¹⁰ See Tod Newcombe, Tired of Service Cuts, California Cities Raise Taxes, GOVERNING, Nov.
27 21, 2012, http://www.governing.com/templates/gov_print_article?id=180367291 (noting that some
28 of these ballot measures passed with 60 to 70% of the vote).

1 approximately \$8.3 million in FY 2012-13 alone. For FY 2013-14 and FY 2014-15, the revenue
2 increases would be considerably larger: annual revenues would increase by approximately \$33-\$34
3 million, respectively. See, e.g., Zielke Report at 44.

4 ii. The City Has Not Charged For Reimbursable Services.

5 In addition to raising taxes, the City could and should charge fees for providing certain
6 services. For example, Stockton has not enacted any measures to defray the costs of emergency
7 response services. Stockton could increase revenues by, for example, filing insurance claims
8 against drivers who cause motor vehicle accidents requiring an emergency response from police or
9 fire services. See Zielke Report at 39. Other “recoverable” costs include responding to building
10 fires and performing other special rescues. Id. at 39-40. If Stockton were to charge for all of these
11 activities, as do other cities identified in the Zielke Report, the City could add approximately
12 \$800,000 in FY 2012-13 and \$1.6 million in additional annual revenues in both fiscal years 2013-
13 14 and 2014-15. Id. at 44.

14 iii. The City Has Not Evaluated Its Saleable Property.

15 The City has identified a small number of real properties as “non-essential,” see Ex. 48
16 (City of Stockton Non-Essential Real Estate), but it has made little progress in valuing these
17 properties and no progress in marketing them for sale or lease. See Locke Dep. 48:3-49:4, Nov. 8,
18 2012. Only *after* filing for protection under Chapter 9 did the City hire a consultant with
19 experience dealing in this type of property. Id. 48:10-11. The City did not complete any formal
20 analysis of the possible value of these properties prior to the Petition Date, id. 55:22-56:4, nor did it
21 even request any assessment evaluation from the San Joaquin County Assessor’s Office, id. 78:19-
22 79:20. To date, outside the rough estimate provided in former Deputy City Manager Michael
23 Locke’s Declaration, see Ex. 47 ¶ 5,¹¹ the City continues to have very little understanding of the
24 value of these properties, Locke Dep. 48:1-49:4, and remains unprepared to lease or sell any of
25 them.

26 ¹¹ The reliability of Mr. Locke’s \$1 million estimate for all “non-essential” properties is dubious in
27 light of the fact that just one of those properties was recently appraised for \$625,000. See Locke
28 Dep. 49:23-50:24.

1 Equally disconcerting is the very narrow group of properties the City labels “non-essential.”
 2 Exhibit 48 omits a number of important, though nonetheless “non-essential,” assets owned by the
 3 City, such as the Marina, the Bob Hope Theatre, the Stockton Events Center, and others. See
 4 Zielke Report at 42-43. Disposing of many of these properties would not only raise money in the
 5 short term, it would relieve the City of the substantial cost of maintaining them. See id. Thus, the
 6 City could add money to its budget from both short-term revenues and a decrease in short- and
 7 long-term expenses.

8 2. Stockton Has No Grasp On Its Finances.

9 Because Stockton bears the burden of proving it was insolvent on the Petition Date, it must
 10 provide “credible proof” of its insolvency. Town of Westlake, 211 B.R. at 867. The City’s
 11 delayed financial reporting and poor financial controls undermine both its ability to make this
 12 showing and its overall “trust us” approach – the testimony of City management and the City’s
 13 recent financial results illustrate that the City both lacked a fair picture of the City’s finances in the
 14 lead-up to the Petition Date and remains unable to generate accurate reporting and reliable
 15 projections.

16 a. Stockton Cannot Produce Timely Or Accurate Financial Reports.

17 In September 2011, then-CFO Susan Mayer described the failures of the administrative
 18 services department as “challenges [that] approach gross negligence that has built up over the past
 19 years and decades. . . . Basic and essential process and controls are simply not in place.” Ex. 163 at
 20 2 (Mem., S. Mayer to L. Montes, Resource Plan for Administrative Services Department, Sept. 12,
 21 2011). Some of the many reported shortcomings of the City’s financial management include:

- 22 • failure to reconcile bank accounts for years;
- 23 • failure to reconcile a housing portfolio of \$100 million to its general ledger since
 24 2008;
- 25 • the accumulation of an “astonishing” \$130 million in inter-fund borrowings through
 26 June 2010; and
- 27 • over-commitment of the capital program in excess of \$20 million.

28 Id. at 3-4. Ms. Mayer also expressed that, due to the City’s financial mismanagement, she was

1 “challenged to cobble together the reliable financial data points necessary to support program and
2 executive team decisions.” *Id.* at 2.

3 In November of 2011, the City’s internal auditor, Maze & Associates, identified several
4 issues that “raise[d] doubts about the adequacy of procedures and the accuracy of certain balances
5 and transactions,” finding that the deficiencies affected “bank reconciliations, investment income
6 allocations, accounts receivable, cash collection site controls, notes and loans receivable, accounts
7 payable, accrued compensated absences, payroll taxability and interfund balances.” Ex. 223
8 (Letter, C. Biggs to Stockton City Auditor F. Taylor, Nov. 4, 2011). As a result of unexpectedly
9 finding Stockton’s fiscal management systems in shambles, the auditor requested a contract
10 amendment to increase the scope of work, noting that “[i]n my 30 years in auditing local
11 government, this is the first time I have had to request a contract amendment because of the
12 identification of so many potential errors and issues which affect prior years.” *Id.* at 2 (emphasis
13 added).

14 As a result of this uncovered gross negligence, Mr. Deis requested that the City Council
15 authorize him to conduct an investigation, as it had become “apparent that there may have existed
16 in certain past fiscal years non-standard financial practices engaged in, either intentionally or
17 negligently, by City administrators and/or or contractors that were not disclosed to the Council and
18 that have also contributed to the City’s current financial situation.” Ex. 68 at 251.36. To date,
19 however, the City has made no public findings regarding this investigation nor issued any
20 remediation policies or guidance to prevent such misconduct in the future. Just this April, the
21 California State Controller initiated its own audit investigation into the financial practices and
22 reporting of the City, noting there is “reason to believe that the City’s ability to provide reliable and
23 accurate financial information relating to the required financial reports is questionable.” Ex. 309
24 (Investigation Letter, J. Chiang to R. Deis, Apr. 2, 2012). The State’s audit is on-going.

25 b. The FY 2010-11 CAFR Was Substantially Delayed And
26 Demonstrates Severe Problems With The City’s Financial Controls.

27 The City’s financial reporting past is prologue. The City’s Charter requires the City to
28 prepare “[a]t the conclusion of each fiscal year, a comprehensive Annual Financial Statement

1 [more commonly termed a Comprehensive Annual Financial Report or “CAFR”] . . . in sufficient
2 detail to show the financial condition of the City’s funds for the preceding year.” Stockton City
3 Charter § 1910. Despite this requirement, Stockton did not publish its FY 2010-11 CAFR until
4 December 11, 2012, nearly 18 months after the fiscal year ended on June 30, 2011. Nor is there
5 any indication that the City has begun work on its FY 2011-12 CAFR, suggesting yet another
6 lengthy delay.

7 The delay in finalizing the FY 2010-11 CAFR becomes even more significant in light of the
8 serious financial controls problems described within. The CAFR identified “Prior Period
9 Adjustments” leading to a reduction of the General Fund balance by \$15.1 million. FY 2010-11
10 CAFR at 536-39; Zielke Report at 12. The CAFR also described 12 material weaknesses¹² and 25
11 significant deficiencies¹³ in the City’s financial controls, as well as other issues with its financial
12 reporting. See FY 2010-11 CAFR at 647-86; see also Zielke Report at 10-12 (discussing
13 problems). These results call the City’s current and future results into serious question.

14 c. Stockton’s Current Financial Management Continues Past Mistakes.

15 The City likes to claim that it is under new management, but new management is making
16 many of the same mistakes as prior City administrations. As explained in the Zielke Report, best
17 practices in local government financial management emphasize the importance of producing both
18 accurate and timely financial reports, because financial reports must be timely and accurate “to
19 meet the needs of decision makers.” See Zielke Report at 14; see also Bobb Report at 15-16.
20 Accordingly, industry standards call for financial reports to be published “as soon as possible after
21 the end of the reporting period.” Zielke Report at 14. Despite years of attempting to get its “fiscal
22 house in order,” Stockton to this day remains unable to produce accurate financial reports within a
23 reasonable time period, even to its City Council or senior staff.

24 _____
25 ¹² “A material weakness is a deficiency, or a combination of deficiencies, in internal control, such
26 that there is a reasonable possibility that a material misstatement of the City’s financial statements
27 will not be prevented, or detected and corrected on a timely basis.” FY 2010-11 CAFR at 647.

28 ¹³ “A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that
is less severe than a material weakness, yet important enough to merit attention to those charged
with governances.” Id.

1 i. The City Council And City's Management Remain In The Dark.

2 Although the importance of understanding mistakes made in the past cannot be
3 overemphasized, the City's focus on cleaning up past errors has come at the expense of producing
4 accurate and timely financial reports to the City Council this year. The City endeavors to reconcile
5 its accounts each month, but it continues to lag far behind what is needed to inform the City
6 Council of the City's current financial position. Burke Dep. 25:17-18, Nov. 15, 2012 ("We are
7 behind schedule due to the CAFR and the cleanup of the prior years."). According to current-CFO
8 Vanessa Burke, the monthly accounting period should close fifteen days after the period's actual
9 end date, followed shortly thereafter by reconciliation. However, the City has failed to close any
10 period within this 15-day window since Ms. Burke was hired, id. at 25:14-21, and as of today, the
11 last period for which the City closed and reconciled its accounts was June 2012.

12 Additionally, budget-to-actual data and fund balance information is not provided on a
13 monthly or even quarterly basis to the City Council, but instead is provided on a "periodic" basis.
14 Id. 49:6-50:15. In practice, this means that financial data is presented to the Council when staff
15 needs its approval of a budget adjustment or appropriation, a practice that led to expensive
16 problems for the City in the past. See, e.g., Goodrich Dep. 189:6-18, Nov. 6, 2012 (describing
17 how, for several years, the City's Human Resources department allowed more than the one
18 permitted dependent to enroll in the City's retiree medical program, and at a vastly undervalued
19 premium, without the City Council's knowledge or approval).

20 Equally problematic, there is no procedure in place currently to ensure that reliable, up-to-
21 date financial information is provided to other members of senior management on a regular basis.
22 The monitoring of budget-to-actual collections is done at the departmental level, but the CFO does
23 not know "what the departments do to monitor" their budgets or expenditures, Burke Dep. 55:8-15,
24 and department heads do not have access to real time, up-to-date budget or spending data, id. 56:2-
25 6. Neither weekly nor monthly monitoring reports are sent to the CFO for review, id. 57:18-58:4;
26 and overviews of the financial performance of the City's funds are only provided to the City
27 Manager "periodically," typically at his request. Id. 49:6-22, 50:12-15. Cash balance reports are
28 prepared monthly, but they are not collected on a centralized basis or provided to the City

1 Manager. Id. 50:16-51:8.

2 It is unclear how the City Council and City Manager can understand the financial condition
3 of the City or sufficiently advise the City Council without regularly provided budget-to-actual, cash
4 flow, or fund balance reports. Mr. Bobb explains that “in a financial crisis, the heart and soul of
5 what a crisis manager does is managing the city’s financial resources, and a manager must have an
6 accurate picture of revenues and expenditures to carry out that responsibility.” Bobb Report at 12;
7 accord Zielke Report at 10-17. The City has provided no evidence that anyone in City
8 management had “an accurate picture of revenues and expenditures” in the lead-up to bankruptcy
9 (or since), and thus the City cannot reasonably expect either creditors or this Court to accept at
10 face-value its financial information or its decisions.

11 ii. The City Still Cannot Produce Timely And Accurate Financial
12 Information.

13 Last week, the City staff presented to the City Council for its approval the year-end
14 numbers for FY 2011-12. Casting still more doubt on the City’s understanding of its finances, this
15 report shows that the City actually ended FY 2011-12 with a General Fund surplus of over \$6.2
16 million.¹⁴ See Dec. 2012 Budget Update at 690. In addition, FY 2012-13 first quarter results show
17 revenues coming in ahead of targets, while expenditures have been below budgeted amounts. Id.;
18 see also Deis Dep. 74:4-76:8. These results not only impeach the City’s credibility with respect to
19 its financial reporting, they independently undermine the City’s case that it was “insolvent” on the
20 Petition Date and that it was legally required to file for bankruptcy at the end of June.

21 The City’s plans for its unexpected surplus also underscore its intention in this case to
22 cramdown on non-labor creditors. Instead of using surplus funds to pay claims of creditors, the
23 City proposes to roll the entire amount¹⁵ into a “reserve for chapter 9 associated costs” for FY
24 2012-13. See Dec. 2012 Budget Update at 698-99. In essence, the City proposes to fund a war

25 _____
26 ¹⁴ This \$6.2 million comprises (i) approximately \$566,000 in budgeted, but unexpended, AB 506
27 funds and (ii) \$5.6 million in other, unexpected revenue gains and cost savings.

28 ¹⁵ The City contends that the \$566,000 in unused AB 506 funds should be considered already-
appropriated for Chapter 9 costs. Dec. 2012 Budget Update at 690.

1 chest for the City's bankruptcy counsel. However, the FY 2012-13 budget already included a total
2 appropriation for bankruptcy costs of over \$5.4 million, \$4 million of which will come from the
3 General Fund. Adding another \$6.2 million is an excessive commitment of resources that could be
4 used to repay creditors, particularly because the City was well below budget projections in FY
5 2011-12 for its AB 506 expenses and litigation costs, and both its bankruptcy and litigation costs
6 are significantly under budget for the first quarter of FY 2012-13. See id. at 705. In light of all of
7 these facts, the City's reservation of an additional \$6.2 million for bankruptcy costs is completely
8 unreasonable; these funds should be treated as what they are – a cash surplus demonstrating that
9 the City was not insolvent on the Petition Date and continues to beat its budget.

10 **B. Stockton Has Failed To Satisfy The Negotiation Requirements For Eligibility.**

11 Stockton has also failed to carry its burden on the two separate negotiation requirements for
12 eligibility. First, Stockton failed to satisfy the Bankruptcy Code's negotiation requirement, either
13 by proving that it "negotiated in good faith with creditors" or that such negotiation was
14 impracticable. See In re City of Stockton, 475 B.R. at 725 (citing 11 U.S.C. § 109(c)(5));
15 Eligibility Br. at 38-41. Second, Stockton failed to satisfy AB 506's requirement that the City
16 negotiate in "good faith" with creditors, and because it thereby failed to satisfy California's
17 authorizing statute, Stockton is not eligible to be a Chapter 9 debtor under 11 U.S.C. § 109(c)(2).¹⁶
18 These failures provide additional bases for dismissal.

19 **1. The City Failed To Negotiate With CalPERS.**

20 The City's forecast of a nearly \$100 million budget shortfall after ten years demonstrates
21 that the City cannot afford its CalPERS liability without raising substantial revenues. See Ask at
22 58. Despite this enormous, planned deficit – brought about by a projected 94% increase in the
23 City's long-term pension benefit costs – the City left its CalPERS liability off the table. Id. at 9.

24 The testimony of the City's management indicates that the City did not seek or even

25 ¹⁶ As fully briefed in Assured's Preliminary Objection, the City's failure to provide complete and
26 accurate financial information during the AB 506 Process violated the good faith requirement of
27 AB 506 and therefore renders this bankruptcy filing without state authorization. Because the City
28 therefore cannot demonstrate it is eligible under section 109(c)(2), its bankruptcy petition should be
dismissed. See Preliminary Objection at 18-19.

1 consider seeking a reduction from CalPERS during the course of the AB 506 Process. See Haase
2 Dep. 129:15-24; Deis Dep. 213:7-13, 214:3-6. Apart from conversations with CalPERS
3 concerning the implementation of the second tier system and a post-petition conversation relating
4 to the logistics of a hardship exemption, Human Resources Director Teresia Haase testified that she
5 could not recall any other conversations with CalPERS regarding the potential modification or
6 reduction of the City's pension obligations. Haase Dep. 129:15-24.¹⁷ Indeed, the City waited until
7 ten days ago to seek a hardship exemption that might reduce Stockton's CalPERS payment by \$4.5
8 million over a three-year period, including \$1.25 million in the current fiscal year alone. See Ex.
9 507 at 4 (Resolution of CalPERS Bd. of Admin. ACT-96-05E, Actuarial Policies – Amortization
10 Periods, Apr. 20, 2005); see also Ex. 508 at 2 (Mem., D. Lamoureux to CalPERS Benefits Program
11 and Admin. Comm., Review of 30 Year Amortization Extension Policy Guidelines, Sept. 14,
12 2010); Ex. 510 at 2 (Attachment 2, Review of 30 Year Amortization Extension Policy
13 Guidelines).¹⁸ CalPERS' General Counsel attended only one AB 506 meeting – with the mediator
14 – and spoke only briefly with the City's bankruptcy counsel for the first time on October 30, 2012,
15 while walking back from a bankruptcy court hearing. Mixon Dep. 63:4-25, Dec. 5, 2012.

16 Nor did the City conduct any financial or other analysis prior to its decision to leave
17 pension and CalPERS off the negotiating table. Ms. Haase testified that she was not aware of any
18 effort to study alternative benefit structures with other pension administrators or agencies to
19 replace the City's participation in CalPERS. Haase Dep. 89:8-13. Nor did the City ever consider
20 withdrawing from CalPERS and placing its existing pension funds on deposit with another pension

21 ¹⁷ Although the City sent a letter to CalPERS in mid-June “to initiate conversations . . . to
22 understand the potential savings to the City as well as the process that will need to be completed in
23 order to limit the annual COLA for Miscellaneous Employees to a maximum of 2 percent,” see Ex.
24 183 at 1-2 (Letter to CalPERS dated June 7, 2012), the City did not actually request any relief from
CalPERS or give CalPERS enough time to respond in any event before the City filed for
bankruptcy. The City's belated attempt to create a paper trail does not evidence any attempt at
negotiation with CalPERS.

25 ¹⁸ To the extent the City belatedly argues that any negotiations with CalPERS would have been
26 fruitless or “impracticable,” the facts indicate otherwise. The City invited CalPERS to attend the
27 AB 506 Process, and CalPERS did not decline. Further, CalPERS' governing statute gives its
board broad discretion to work with municipalities, to adjust discount rates, and to stretch
28 repayment horizons, and the City's failure to even request a hardship exemption from CalPERS
indicates it was not interested in even exploring any options CalPERS might be able to facilitate.

1 administrator, such as what was done in San Francisco. See Lamoureux Dep. 93:19-97:3, Nov. 16,
2 2012. In fact, it was not until August – over a month after the Petition Date – that the City began to
3 develop justifications for “remaining current and in good standing with CalPERS.” See Ex. 154
4 (Meeting Notes re: CalPERS Business Case, Aug. 8, 2012). The City’s hands-off approach to
5 CalPERS – the City’s largest creditor – is far from mediation process required by AB 506. See,
6 e.g., Cal. Gov’t Code §§ 53760.3(d)-(i) (emphasizing the neutral evaluator’s important role in
7 establishing the good faith of municipal bankruptcy negotiations). By failing to negotiate at all
8 with CalPERS, the City cannot claim to have negotiated in good faith for purposes of 11 U.S.C.
9 § 109(c)(5).

10 a. The City Manager’s Ex Post Facto Concern Over A “Mass Exodus”
11 And “Municipal Chaos” Is Unfounded and Mere Pretext.

12 The City may seek to excuse its failure to negotiate with CalPERS by arguing that any
13 alteration in pension benefits would trigger a “mass exodus” of Stockton employees and
14 “municipal chaos.” See, e.g., Ex. 109; Deis Dep. 191:22-192:1. To be clear, Assured has a
15 significant stake in the stability and future viability of Stockton. However, Assured disagrees with
16 the City’s assumption that if it tackled its biggest financial problem – CalPERS pension benefits –
17 disaster would result. As illustrated below, neither credible evidence nor studies support the City’s
18 claimed fear of a “mass exodus” or “municipal chaos.” See Brann Report at 10-18; Neumark
19 Report at 6-19.

20 The City previously has claimed that any reduction in pension benefits for existing or future
21 retirees would likely result in “an employee mass exodus.” Ex. 109 at 4. That assertion ignores
22 the fact that Stockton, with an October 2012 unemployment rate of 13.6%, Zielke Report at 25, and
23 only eight (8) open positions listed on its website, City of Stockton Employment Opportunities,
24 <http://www.stocktongov.com/government/departments/humanResources/oppPos.html> (last visited
25 Dec. 13, 2012), has no problem recruiting or retaining workers. In reality, Stockton’s actual
26 contention is that it must retain its CalPERS plan for all 1,400 employees – not due to concerns of a
27 “mass exodus” – but due to its concern over the unlikely departure of 20-40 experienced police
28 officers.

1 Stated differently, the City is willing to assume hundreds of millions of dollars of pension
2 liabilities (which it states it cannot afford) and remain in the CalPERS system because it believes
3 that doing so may help the City retain 20-40 experienced police officers and possibly recruit other
4 experienced officers. Jones Dep. 132:4-133:6. No doubt there are other, far less costly, means by
5 which the City could address attrition and police recruitment without boxing the City and its
6 citizens into paying hundreds of millions in future pension liabilities. See Neumark Report at 21-
7 22.

8 The City has provided no evidence that a modest reduction in pension benefits would cause
9 senior police officers to leave. Id. at 16. In fact, the City has conducted no analysis whatsoever
10 concerning what level of impairment would endanger officer retention. Jones Dep. 211:17-23.
11 Instead, it complains based on anecdotal evidence that experienced senior officers have already
12 gone to other police departments because of pay and benefit cuts. See Jones Dep. 128:16-21. Data
13 produced by the City shows that 27 officers transferred this year to other jurisdictions, 16 with
14 more than a decade of experience. See Report, Stockton Police Department, Sworn Officer Count,
15 at 32-35 (current through Nov. 26, 2012) (“SPD Sworn Officer Count”); Report, Stockton Police
16 Department, Sworn Officers Leaving from 2008 through Sept. 11, 2012 (“SPD Sworn Officer
17 Experience Levels”). Between 2008-2012, 21 officers with more than 10 years of experience have
18 transferred. Compare SPD Sworn Officer Count with SPD Sworn Officer Experience Levels.
19 These transfer rates are consistent with transfer rates throughout California and elsewhere and do
20 not support a concern of “mass exodus.” Brann Report at 16 (discussing studies conducted in
21 California and elsewhere and comparison to Stockton).

22 Looking at the Stockton data, the vast majority of lateral departures over the past five years
23 have been transfers away from the economically-depressed Central Valley. These are essentially
24 lifestyle changes and relocations to agencies in geographically advantageous locales, such as those
25 along the Pacific coast, in the Bay Area, or the mountains. Brann Report at 12; Neumark Report at
26 8. Decisions to relocate to a different geographic area clearly were based on a number of factors,
27 and such lifestyle transfers cannot be blamed on a concern with either past wage and benefit cuts or
28 possible pension changes. Brann Report at 12; Neumark Report at 10 (“[M]any factors besides

1 economic gains influence migration and decisions about where to work.”).

2 Indeed, employees take into account, not just pensions, but a wide range of factors when
3 considering a job move. See Neumark Report at 8-11. First, police officers may have departed in
4 the past because of the police union’s turbulent relationship with the City, but the recent City-
5 police union agreement offers the prospect of labor peace that would likely reduce lateral transfers.
6 See Jones Dep. 134:10-20; Brann Report at 13-14. Second, ties to community, housing costs, and
7 many other factors unrelated to compensation discourage police officers from moving for a new
8 job. See Neumark Report at 9, 12, 17-19. Third, seniority is a strong factor that discourages lateral
9 transfers, as the transferring officers lose their seniority and must start anew next to the rookies at
10 the new agency, getting the worst shifts and assignments. Brann Report at 14. Fourth, the
11 adoption by many California police agencies of lower second tier pension benefits that may apply
12 to a transferee reduces the likelihood that experienced officers will leave for another agency that
13 offers those lower pension benefits. Brann Report at 15. Finally, an officer’s transfer to another
14 agency would not have any effect whatsoever on a reduction to that officer’s Stockton pension
15 benefits, as Stockton alone remains liable for benefits accrued during the employee’s tenure with
16 the City. Lamoureux Dep. 132:2-23.

17 In short, the City tilts at a “mass exodus” windmill, even though many factors provide a
18 strong incentive for officers to stay in Stockton and no credible evidence supports the City’s fears.

19 b. The Evidence Refutes The City’s Claim That It Cannot Recruit New
20 Officers Given The Uncertainty Over Pensions.

21 The City also argues that pension reductions would hinder police recruitment, Ex. 109 at 4,
22 and that “recruitment has become in [2012] a progressively worse problem.” Jones Dep. 171:11-
23 12. This is false, as the evidence shows that the City can and, in fact, does, recruit candidates to
24 meet staffing needs.

25 First, the City’s own data and testimony shows that it has hired “upwards of 70 new
26 officers” this year. See Jones Dep. 163:13-14. In fact, the number of sworn officers hired by the
27 City during 2012 is at least 77. See SPD Sworn Officer Count (showing 2012 sworn officer hiring
28 statistics of 18 [1Q], 18 [2Q], 13 [3Q], and 15 [4Q] through November 26, 2012); Dec. 2012

1 Budget Update at 12 (additional 4 academy graduates and 9 academy trainees hired in December).
2 Moreover, the SPD will reach its authorized staffing of 344 police officers by year's end,
3 notwithstanding what Chief of Police Eric Jones deems to be below-market compensation and
4 benefits. See Ex. 38 at 6:5-6 (Decl. of Eric Jones), see also Jones Dep. 204:18-20; Dec. 2012
5 Budget Update at 11-12. In fact, approximately 1,300 applicants underwent physical agility testing
6 at an SPD recruiting event this week.¹⁹

7 Second, existing research indicates that most younger employees pay relatively little
8 attention to pensions. Neumark Report at 14-16. The police department's internal documents bear
9 this out. In the first nine months of 2012, academy graduate applications were four times higher
10 than in 2008, undercutting any claim that applicants were concerned about pension uncertainty.
11 See Report, Stockton Police Department, Sworn Officer Hiring Statistics (2008-9/17/2012). The
12 new pension law²⁰ also makes the City's pension concern irrelevant, as all new police officers hired
13 after January 1, 2013 statewide will receive the same reduced pension benefits. Thus, the City's
14 claims about pension uncertainty harming both recruitment and retention are not credible.

15 2. Stockton Failed To Negotiate With Assured.

16 Stockton also failed to satisfy § 109(c)(5) because it refused to negotiate with Assured.
17 Throughout the AB 506 Process, Assured attempted to engage the City in productive discussions
18 regarding repayment options on the Pension Obligation Bonds and potential efficiencies and
19 sources of revenue the City could access. Assured offered to make its financial advisor (Alvarez &
20 Marsal) available to the City to discuss alternatives to avoid bankruptcy. The City repeatedly
21 rebuffed all attempts to discuss any repayment of the Pension Obligation Bonds other than the
22 proposal set forth in the Ask, which was based on ten-year projections prepared without the benefit
23 of a completed CAFR or other timely and reliable financial information. In other words, the City

24 ¹⁹ "Record Number of Stockton Police Hopefuls," THE RECORD, available at
25 http://www.recordnet.com/apps/pbcs.dll/article?AID=/20121213/A_NEWS/212130322 (Dec. 13,
2012) (quoting Stockton Police Department spokesman, Joe Silva).

26 ²⁰ On September 12, 2012, Assembly Bill 340 (AB 340), the California Public Employees' Pension
27 Reform Act of 2013 (PEPRA) was signed into law. PEPRA will introduce substantial changes to
28 pension benefits for new public employees hired after January 1, 2013, and some changes that
affect current public employees.

1 told Assured to “trust it.” As illustrated by the City’s latest financials, even the City’s short-term
2 projections are consistently untrustworthy and cannot be the basis for either reasoned decision-
3 making or permanent impairment. See In re Bridgeport, 129 B.R. at 338 (“Obviously it is
4 necessary for cities to make informed financial projections. It is just as obvious that the longer the
5 projection, the less informed the conclusion.”).

6 The City’s take-it-or-leave it approach does not satisfy the standard for good faith
7 negotiation. For example, in In re Ellicott School Building Authority, the court held that even
8 though the debtor conducted three public meetings explaining its proposed plan of restructuring to
9 bondholders, it did not negotiate in good faith because it indicated that the economic terms of its
10 proposed plan were nonnegotiable. 150 B.R. 261, 266 (Bankr. D. Colo. 1992); see also Sullivan
11 County, 165 B.R. at 78-79 (“The ‘creditor protection’ provided by *section 109(c)(5)* . . . insures
12 that the creditors have an opportunity to negotiate concerning a plan on a level playing field with
13 the debtor before their rights are further impaired . . .” (citation omitted)). Because Stockton
14 refused to negotiate with Assured in good faith, its petition should be dismissed.

15 3. Negotiations Were Not Impracticable.

16 The City alternatively argues that negotiations were unlikely to succeed “because (1) the
17 number of parties competing for too few dollars made it highly unlikely that a global restructuring
18 plan would be achieved in a voluntary setting; and (2) it could not bind its numerous retirees to any
19 deal negotiated in the AB 506 process.” Eligibility Br. at 40. However, the City refused to put on
20 the table either its taxing power or any of the hundreds of millions of dollars it proposes to pay to
21 CalPERS on account of its pension liability. The refusal to place two of its largest assets on the
22 table cannot excuse Stockton from the need to negotiate in good faith with creditors. See, e.g.,
23 Sullivan County, 165 B.R. at 82 (concluding that municipal debtors did not negotiate in good faith
24 because they filed for bankruptcy rather than attempting to exercise their assessment powers to pay
25 debt obligations).

26 Likewise, the City cannot argue that it could not bind retirees to a modified retiree medical
27 plan outside of a bankruptcy. The City has the power outside of bankruptcy to bind current retirees
28 to negotiated changes in healthcare benefits. The Stockton City Charter provides that “[t]he City

1 Council shall provide for a retirement and death benefit plan for officers and employees of the
2 City.” City Charter § 2600. And the City’s Collective Bargaining Agreements typically require
3 the City to continue to provide coverage to certain retirees “under the City’s Modified Employee
4 Medical Plan.” Yet these commitments do not prevent, and have not prevented, the City from
5 negotiating changes to the Medical Plan that reduce the City’s retiree medical expenses. In a Letter
6 Agreement between the City and the Stockton City Employees Association dated Nov. 15, 2010,
7 for example, the parties agreed to a variety of co-pay increases and increases in deductibles in the
8 Medical Plan. See Ex. 497 (Letter Agreement Between Stockton and SCEA). Mr. Deis testified
9 that through such agreements, which applied to both active employees and retirees, the City
10 obtained a 30% reduction in employee medical expenses. See Deis Dep. 240:4-241:24. The City
11 could have similarly negotiated substantial cost savings in its retiree medical plan during the AB
12 506 Process, and bound retirees thereby.

13 The mere possibility of litigation over the existence and scope of an entitlement does not
14 create that entitlement or excuse the City from negotiating in good faith over the contours of any
15 such entitlement. “In order to state a claim for a contractual right to [medical benefits in
16 California, retirees] must plead specific resolutions or ordinances establishing that right.” Harris v.
17 County of Orange, 682 F.3d 1126, 1134 (9th Cir. 2012). The City’s contracts and past practice
18 give the City a strong legal position for modification through the collective bargaining process.

19 Neither the City Charter nor the parties’ bargaining history establish that any particular
20 level of retiree medical benefits and expenses had vested and could never be changed. See, e.g.,
21 id. at 1135 (“Retirees have failed to plead facts that suggest that the County promised, in the
22 MOUs or otherwise, to maintain the Grant [of healthcare benefits] as it existed on the Retirees’
23 respective dates of retirement.”); Retired Employees Assn. of Orange County, Inc. v. County of
24 Orange, 266 P.3d 287, 298 (Cal. 2011) (“Vesting remains a matter of the parties’ intent.”). In the
25 Orange County case, the retirees argued that they had a vested right to have their premiums
26 determined through a combined experience pool with the county’s active employees, pointing, as
27 evidence of that intent to vest, to a twenty-seven year uninterrupted history of the county utilizing
28 such a unified pool. Id. at 289. The court cautioned that, “as with any contractual obligation that

1 would bind one party for a period extending far beyond the term of the contract of employment,
2 implied rights to vested benefits should not be inferred without a clear basis in the contract or
3 convincing extrinsic evidence.” Id. at 299. Here, by contrast, the City substantially modified
4 retiree medical benefits as recently as 2010 – bringing no lawsuit by retirees – which demonstrates
5 that the City, the unions, and the retirees all intended and understood that such benefits would
6 remain subject to negotiation.

7 It appears the City does not need bankruptcy to bind retirees to substantial changes in
8 medical benefits. It has done so before, and it can do so again. It simply needed to negotiate the
9 details of a modified Medical Plan in good faith with its unions. Through such negotiations, the
10 City could, among other options, obtain needed co-insurance and deductible reforms, offer
11 alternative plan structures (such as a high deductible or Kaiser plan), or work with the unions to
12 develop other creative solutions (like what the City has proposed in its MOU with its police union).
13 The City’s failure to do so does not make it eligible for Chapter 9.

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

15 Finally, the City’s bankruptcy petition should be dismissed because the City did not file this
16 case in good faith. The City’s lack of good faith is evidenced in two ways.

17 First, the City’s entire purpose in filing this case has been to force Assured and the other
18 Capital Market Creditors to pay for otherwise-unfunded benefits for labor – including CalPERS’
19 ever-increasing pension benefit costs. For a petition to be filed in good faith, “[t]he evidence needs
20 to show that the ‘purpose of the filing of the chapter 9 petition not simply be to buy time or evade
21 creditors.’” In re City of Vallejo, 408 B.R. 280, 295 (B.A.P. 9th Cir. 2009) (citing COLLIER ON
22 BANKRUPTCY ¶ 109.04[3][d]). Likewise, bankruptcy cannot be used to target one group of
23 creditors for the comfort of another.

24 Second, as explained at length above, the City rushed into bankruptcy instead of making the
25 hard decisions on revenues and expenses that would put its fiscal house in order. A municipal
26 debtor must tenaciously pursue alternative avenues to bankruptcy before it can file in good faith for
27 purposes of 11 U.S.C. § 921(c). See In re N.Y. Off-Track Betting Corp., 427 B.R. 256, 282
28 (Bankr. S.D.N.Y. 2010); COLLIER ON BANKRUPTCY ¶ 921.04[2]. Like the debtors in Sullivan

1 County, Stockton refused to attempt a revenue solution for the debt it created through years of
2 financial recklessness, and like those debtors, its petition should be dismissed. 165 B.R. at 82; see
3 also In re Valley Health Sys., 383 B.R. 156, 160 (Bankr. C.D. Cal. 2008) (section 921(c) requires
4 dismissal if debtor is not eligible for relief under Chapter 9). The City should be required to
5 continue right-sizing its balance sheet outside of bankruptcy instead of using its operating surplus
6 to fund an unfair war against its funded debt.

7 **III. CONCLUSION**

8 For the foregoing reasons, Assured respectfully requests that the Court DENY the City's
9 Chapter 9 petition, dismiss this bankruptcy case, and grant such other further relief as the Court
10 may deem proper.

11 Dated: December 14, 2012

Respectfully submitted,

12
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14
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