18

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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA
SACRAMENTO DIVISION

In re: CITY OF STOCKTON, CALIFORNIA, Debtor.	**Case No. 12-32118** **D.C. No. OHS-5** **Chapter 9** **REPLY BRIEF OF CAPITAL MARKETS CREDITORS REGARDING THE CITY OF STOCKTON'S MOTION FOR ORDER RULING THAT APPROVAL OF SETTLEMENT AGREEMENT IS NOT REQUIRED UNDER BANKRUPTCY RULE 9019** Date: January 30, 2013 Time: 10:00 a.m. Dept.: C, Courtroom 35 Judge: Hon. Christopher M. Klein

I. PRELIMINARY STATEMENT[1]

At the preliminary hearing on the 9019 Motion, the Court framed the dispute as involving two interrelated questions: "Does the Court have authority to approve or disapprove a compromise? And if the answer is no, then the next question is: What about the chapter 9 process provides some kind of protection or policing?" Transcript of Hearing (Nov. 20, 2012) at 87-88 [Dkt. No. 624].

In response, the City claims that the answer to the first question is no, urging that the Court has absolutely no power or authority to consider any settlement the City wishes to consummate. The City, however, fails to cite a single case or authority so holding, and all case law and chapter 9 practice is to the contrary. The City also ignores the Court's second question, by omission answering that there is no "protection" or "policing" of a municipal debtor's actions with respect to prepetition liabilities in a chapter 9 case. The City envisions an utterly one-sided chapter 9 landscape, in which the debtor is free to act with impunity and without judicial oversight while creditors (at least those not favored with pre-plan compromises and payments) are subject to the automatic stay, deprived of notice and the opportunity for a hearing, and otherwise powerless to act (as the City eagerly demonstrated when faced with requests by the retirees and the *Price* plaintiffs for relief from the stay in an effort to pursue state-court rights and remedies).

The result, in the City's imaginary regime, would be a municipal debtor that is free to evade all of the core provisions of chapter 9 – including the mandate of equal treatment of similarly-situated creditors, the prohibition on unfair discrimination, and the requirement that a plan be in the best interests of creditors – simply by "compromising" and paying disputed prepetition claims held by influential or favored creditors and leaving the scraps for those less favored and those who have the temerity to question the debtor's conduct. As shown below, the fundamental requirements of chapter 9 are not so easily discarded.

For its part, CalPERS – the City's most favored claimant (and one that stands to benefit from the City's legal position) – mimics the City's argument that the Court is powerless to consider postpetition settlements of claims against a municipal debtor. CalPERS then asserts that the only

[1] Capitalized terms not defined in this Reply Brief have the meanings given to them in the Capital Markets Creditors' Supplemental Brief [Dkt. No. 656] ("CMC Supp. Br."). The supplemental briefs of the City and CalPERS are cited as "City Br." and "CalPERS' Br.", respectively.

"protection" or "policing" power available to the Court would be in the context of an after-the-fact motion to dismiss the case or denial of a proposed plan of adjustment.

Here again, chapter 9 is not so toothless. Chapter 9 incorporates numerous statutory provisions addressing "adjustment of the debtor-creditor relationship," which the Court has found to be at "[t]he core of a chapter 9 case." *In re City of Stockton*, 478 B.R. 8, 25 (Bankr. E.D. Cal. 2012). Those provisions include section 502 – which permits parties in interest to object to claims and empowers the Court to determine allowance of claims – and make clear that the review of a compromise of claims against the City must be conducted on a contemporaneous basis, not after a settlement has been consummated and the horse has left the barn.

CalPERS also seeks to re-litigate the Court's prior holding that "the municipality's voluntary act of filing a chapter 9 case triggers" the "consequence" of "the municipality consent[ing], within the meaning of § 904, to interference by a federal court as to the Bankruptcy Code provisions that apply in chapter 9 cases." *Id.* at 22. Offering a preview of arguments it will make to try to justify the City's proposed unimpairment of the CalPERS claim, CalPERS asserts that the Court got it wrong, contending that even the provisions of the Bankruptcy Code expressly incorporated into chapter 9 – including section 502 – are inoperative unless and until the City deigns to "consent" to their application in any particular instance and the State does not otherwise veto the City's decision. As explained below, CalPERS's interpretation of sections 903 and 904 is dead wrong, as the Court already has concluded in this very case.

For all the reasons set forth below and in the Capital Markets Creditors' prior briefs, the Court should conclude that the City is required to seek and obtain the approval of the Court before implementing any proposed compromise of its disputed prepetition liabilities, and therefore deny the 9019 Motion to the extent that it seeks to exempt the City from so doing.

II. BANKRUPTCY RULE 9019 APPLIES IN CHAPTER 9 CASES

Neither the City nor CalPERS takes issue with the fact that, by its terms, Rule 9019 is facially applicable in chapter 9 cases. Nor could they. Unlike certain other Bankruptcy Rules, the

application of Rule 9019 is not limited to particular chapters of the Bankruptcy Code and, per Rule 1001, Rule 9019 applies "in cases under title 11." *See* CMC Supp. Br. at 3.[2]

Instead, the City and CalPERS spill pages of ink establishing the uncontroversial and uncontroverted point that the Bankruptcy Rules do not create new "substantive rights." They then point to cases concluding that section 363 of the Bankruptcy Code provides one statutory basis for Rule 9019, note that section 363 is not incorporated into chapter 9, and leap to the conclusion that there is no "substantive underpinning" that could require the Court's approval of a settlement in a municipal bankruptcy case. City Br. at 3-4; CalPERS Br. at 3-4.

The logical flaw in this argument is that it assumes that section 363 is the ***sole*** statutory basis for Rule 9019. It is not. Section 363 involves the use or sale of property of the estate, and therefore provides the statutory "underpinning" for compromises involving the estate's disposition of property – particularly affirmative causes of action owned by the estate. Every single case cited by the City and CalPERS for the proposition that section 363 serves as the only possible foundation for Rule 9019 involved a settlement of the estate's claims against a third party, and the courts considering the proposed compromises at issue in those cases therefore naturally invoked section 363:

- "[T]he disposition by way of 'compromise' of ***a claim that is an asset of the estate*** is the equivalent of a sale of the intangible property represented by the claim, which transaction simultaneously implicates the 'sale' provisions under section 363 as implemented by Rule 6004 and the 'compromise' procedure of Rule 9019(a)." *In re Mickey Thompson Ent. Group, Inc.*, 292 B.R. 415, 421 (9th Cir. BAP 2003) (emphasis added) (involving settlement of fraudulent transfer claims).

- The debtor's "claims against Chrysler constituted ***estate property*** within the meaning of Section 363 . . . . [T]he Trustee's act of agreeing to settle [the debtor]'s claims

[2] Rule 9019(a) involves a "motion by the trustee." Bankruptcy Rule 9001 makes the definitions of section 902 of the Bankruptcy Code applicable to the Bankruptcy Rules by providing that "[t]he definitions of words and phrases in . . . § 902 . . . of the Code . . . govern their use in these rules." Section 902(5) of the Code provides that the term "'trustee', when used in a section that is made applicable in a case under this chapter by section 103(e) or 901 of this title, means debtor, except as provided in section 926 of this title." 11 U.S.C. § 902. Consequently, Rule 9019's reference to a "trustee" is a reference to the debtor in a chapter 9 case.

against Chrysler constituted a sale of that claim." *Northview Motors, Inc. v. Chrysler Motors Corp.*, 186 F.3d 346, 350 (3d Cir. 1999) (emphasis added) (involving settlement of debtor's claims for breach of contract and related causes of action).

- "Settlement agreements frequently involve the ***disposition of assets of the estate***. The Code contemplates these transactions, but restricts a trustee's ability to use and sell such assets. . . . The instant agreement compromised an asset of the debtors' estate." *In re Martin*, 91 F.3d 389, 394-95 (3d Cir. 1996) (emphasis added) (involving settlement of debtor's claims for breach of contract).

- "Settlement agreements frequently involve ***disposition of the estate's assets***. The transaction may involve the 'use', or possibly the 'sale', of estate assets outside of the ordinary course of business. Under § 363 such 'use' or 'sale' is permitted only 'after notice and a hearing.'" *In re Sparks*, 190 B.R. 842, 844 (Bankr. N.D. Ill. 1996) (emphasis added) ("In this case, the terms of the settlement . . . required the sale of the Property . . . .").

- "[W]hen a compromise/settlement involves the exchange of property, the line between it and a sale begins to blur." *In re Dow Corning Corp.*, 198 B.R. 214, 245 (Bankr. E.D. Mich. 1996) (involving a compromise of debtor's claims against an insurer).

Other compromises, however, involve prepetition claims asserted ***against the debtor***.[3] Section 363 does not speak to those settlements, which instead are governed by section 502 of the Bankruptcy Code. The City's lead case, *In re Telesphere Communications, Inc.*, 179 B.R. 544 (Bankr. N.D. Ill. 1994), nicely illustrates this distinction. In *Telesphere*, the court considered a proposed settlement of the estate's claims against third parties arising from the debtor's prepetition

[3] The City strangely claims that "[t]he Capital Markets Creditors . . . appear to have abandoned the argument that these cases are distinguishable on the grounds that they involved settlement of claims held *by* the City as opposed to claims *against* the City." City Br. at 4 n.3 (emphasis in original). To the contrary, this key distinction was noted in the Capital Markets Creditors' original objection to the 9019 Motion, at the preliminary hearing on the 9019 Motion, and in the Capital Markets Creditors' Supplemental Brief, which states that, "[c]ontrary to the City's assertions, Rule 9019 is not limited, by its language or otherwise, to implementing section 363 or any other particular section of the Bankruptcy Code. Rather, Rule 9019 has a myriad of statutory bases, including section 502 (regarding allowance of claims) and sections 943 and 1129 (regarding the payment on and treatment of claims). *See, e.g.*, *In re Columbia Gas Sys.*, Case No. 91-803, 1995 Bankr. LEXIS 936 (Bankr. D. Del. June 16, 1995) (approving Rule 9019 settlement premised on section 502)." CMC Supp. Br. at 5 n.3.

leveraged buyout, concluding that "[t]he settlement presented by the pending motion is subject to court review, since the trustee is seeking to liquidate ***assets of the estate*** – certain avoidance claims – and notice and a hearing is required, under Section 363(b) of the Code, for any use or sale of estate assets out of the ordinary course." *Id.* at 552 (emphasis added). The court specifically noted that "[t]he settlement of ***a cause of action held by the estate*** is plainly the equivalent of a sale of that claim. There is no difference in the effect on the estate between the sale of a claim (by way of assignment) to a third party and a settlement of the claim with the adverse party." *Id.* at 552 n.7 (emphasis added).

The *Telesphere* court then contrasted the situation implicated when a debtor settles a claim asserted ***against*** the estate:

> [C]ourt approval is ordinarily not required in the process of allowing a claim against the estate. Claims filed pursuant to Section 501 of the Code are automatically allowed, pursuant to Section 502(a) unless an objection is filed under Section 502(b). Thus, if a dispute between a creditor and trustee is settled by the filing of a claim in an agreed amount, no bankruptcy court approval would be necessary ***unless some other party filed an objection to the claim***.

Id. at 552 n.6 (emphasis added) (internal citation omitted). In other words, section 502 affords parties in interest the right to review and object to compromises of claims against the estate. Section 502 therefore provides the "substantive underpinning" (to use the City's phraseology) for Rule 9019's requirement of notice and a hearing with respect to settlements involving claims asserted against the debtor.

Indeed, as summarized in the Capital Markets Creditors' Supplemental Brief, chapter 9 contains a very clear and specific claims allowance process that, among other things, specifically affords creditors the right to object to claims and the assurance that unknown claims (*i.e.*, claims not listed or filed) and disputed claims will either be (a) discharged or (b) formally adjudicated in an open claims allowance process in which creditors are given notice and an opportunity to be heard. *See* CMC Supp. Br. at 4-5. All of this furthers "the bankruptcy policy of favoring a collective proceeding to work out a comprehensive solution to municipal insolvency." *City of Stockton*, 478 B.R. at 26.

Notably, the title of chapter 9 itself is "Adjustment of Debts of a Municipality" – that is the very purpose of the chapter. *Id.* at 25. Settlements of disputed claims against the debtor are nothing other than a form of "adjustment of debts." Without a requirement that proposed settlements of disputed claims against the debtor be subject to notice and the opportunity for hearing, the entire claims allowance process – and the "collective proceeding" cited by the Court – would be rendered meaningless, as any municipal debtor would be free to "compromise" any and all disputed claims – whether or not listed, subject to a timely-filed proof of claim, or otherwise – without even notifying creditors and before proposing, much less confirming, a plan of adjustment.

The claim referenced in the 9019 Motion provides a perfect example. The City listed the claim – for damages due to alleged use of excessive police force – as disputed, meaning that in the normal course the claim either would be discharged (if no proof of claim was filed) or subject to the claims objection and allowance process (if a proof of claim was filed). The Capital Markets Creditors and others would have the right to be heard with respect to allowance of the claim. By the proposed compromise, the City seeks to dispose of the objection and allowance process and to remove the claim from the case, not by discharging it but by allowing and then paying it. If section 502 and the other statutory provisions governing the allowance and treatment of claims in a chapter 9 case mean anything, they mean that creditors are entitled to be heard with respect to such resolution.[4]

The City's only response is to note that the holder of the disputed claim at issue here "has not filed a proof of claim, and, necessarily, neither the City nor any other party has objected to such non-existent proof of claim. As neither of these pre-requisites has occurred, section 502 is not applicable." City Br. at 17-18. But that is precisely the point – absent the settlement, the claimant would be required to file a proof of claim and creditors would be entitled to object to that claim. The

[4] This is why chapter 9 debtors – including those represented by the City's counsel in this case – routinely invoke Rule 9019 and seek court approval of proposed compromises. *See* CMC Supp. Br. at 3-4. The City's attempt to distinguish that routine practice as involving debtors with "little incentive not to seek court approval" (City Br. at 5) is nonsensical, and begs the question of what "incentive" the City has in this case to evade court approval.

City cannot eviscerate that fundamental creditor protection by settling a disputed claim before a bar date has been established, thus unilaterally exempting that claim from the claims allowance process.[5]

For all of these reasons, there exists ample "substantive underpinning" for the requirement of court approval of proposed compromises of prepetition claims against the debtor in a chapter 9 case.

III. SECTION 904 OF THE BANKRUPTCY CODE DOES NOT LIMIT THE COURT'S AUTHORITY TO REVIEW SETTLEMENTS

The City next argues that, even if there is a statutory basis for court approval of compromises in a chapter 9 case, section 904 of the Bankruptcy Code "trumps" the other provisions of the statute and "bars the Court from requiring approval of settlements and compromises." City Br. at 6. In so doing, the City expands section 904 well beyond any logical reading and contradicts holdings the Court already has made in this case.

The City first claims that review of proposed settlements would enable the Court "to dictate the amount to be paid in a given settlement" and even "dicat[e] to the City what it should pay its employees and what benefits it is permitted to offer to the members of its labor unions." City Br. at 7 and 8. This hyperbole is specious. Consideration of a settlement is a thumbs up / thumbs down exercise governed by well-established standards – the Court has no authority to "dictate" the terms of any compromise, whether in chapter 9, chapter 11 or otherwise.[6]

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[5] The City's stilted interpretation of section 502, coupled with its failure to seek a bar date, cannot be used to undermine the fundamental rights of creditors in this case. The Capital Markets Creditors reserve the right to petition the Court to establish a claims bar date as soon as reasonably practicable.

[6] The City points to its proposed settlement with the SPOA as an example of the unwarranted intrusion into "governmental powers" that would occur if the Court were empowered to review compromises regarding prepetition claims. City Br. at 7-8. In fact, however, the Capital Markets Creditors have never suggested, and do not suggest, that all of the terms and conditions of the City's collective bargaining agreements are now within the purview of the Court (although they would be if the City sought to assume or reject those agreements, *see In re County of Orange*, 179 B.R. 177 (Bankr. C.D. Cal. 1995)). Rather, as noted in the Capital Markets Creditors' Supplemental Brief, the City's settlement with the SPOA is much broader than a typical labor agreement, and includes core bankruptcy matters involving settlement and allowance of disputed claims against the City and agreements to vote in favor of the City's not-yet-proposed plan of adjustment. *See* CMC Supp. Br. at 2, 10-11. To the extent that issues of claim allowance and plan approval are contained in the same agreement as issues of employee wages and benefits, the issues easily can be segregated, with the Court reviewing the bankruptcy matters that are at the "core" of the chapter 9 case.

The City next claims that section 904 must be read to preclude Court review of any settlement or compromise due to "the Tenth Amendment sovereignty concerns that underlie section 904." City Br. at 12. But the Court already has held that, by voluntarily filing a petition under chapter 9, the City (and the State) "consents, within the meaning of § 904, to interference by a federal court as to the Bankruptcy Court provisions that apply in chapter 9 cases." *City of Stockton*, 478 B.R. at 22. This means that, notwithstanding whatever section 904 otherwise might provide, the City has consented to the application of section 502 and chapter 9's claims adjustment process, including the corollary application of Bankruptcy Rule 9019. The City's lengthy discourse on "the history of section 904" (City Br. at 10-14) simply ignores the Court's prior holding in this regard.[7]

Thus, as the Court already has held, section 904 does not provide some sort of governor or limitation on the statutory provisions of the Bankruptcy Code that are incorporated into chapter 9.[8] The City has consented to the full force and operation of each and every one of those provisions (including section 502) by filing this case. Section 904 (which applies to limit "any power of the court" not "any provision of this title") merely serves to limit ***the Court's*** extra-statutory powers where the exercise of such authority would interfere with the City's political or governmental powers:

> [Section 904] can only mean that a federal court can use no tool in its toolkit – no inherent authority power, no implied equitable power, no Bankruptcy Code § 105 power, no writ, no stay, no order – to interfere with a municipality regarding political or governmental powers, property or revenues, or use or enjoyment of income-producing property.

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[7] The City, however, does make clear its desire to have a unilateral bankruptcy process unrestrained by any provision of the Bankruptcy Code, questioning the "constitutionality" of various basic bankruptcy provisions incorporated into chapter 9. City Br. at 13 n.5. If the City did not want to play by the statutory rules, it should not have commenced this case in the first place.

[8] Even CalPERS admits that the Court is empowered to evaluate the propriety of the City's settlements in connection with the plan process. CalPERS Br. at 5. Because section 904 exempts the plan process from any limitation it places on the authority of the Court, neither CalPERS nor the City could take any other position. Thus, according to the logic of the City and CalPERS, the Court is authorized to evaluate the City's compromises and settlements in connection with a plan of adjustment but may not do so if such compromises and settlements take place one day before a plan is proposed.

City of Stockton, 478 B.R. at 20. In other words, section 904 "functions as an anti-injunction statute," *id.*, ***not*** as a limitation on the operative and incorporated provisions of chapter 9.[9]

The City's convoluted attempt to escape the plain language, intent, and effect of section 926 only illustrates the error of its argument. As noted in the Capital Markets Creditors' Supplemental Brief, section 926 authorizes a bankruptcy court to appoint a trustee to pursue avoidance of prepetition transfers to the extent that the municipal debtor declines to do so. The City contends that section 904 "trumps" section 926 and immunizes any and all prepetition transfers from avoidance where the municipal debtor has authorized those transfers "in the exercise of [its] political or government functions." City Br. at 14. But, as the legislative history makes clear, the entire point of section 926 is to permit avoidance of transfers that the debtor previously authorized in exercise of its political powers:

> [The ability to appoint a trustee pursuant to section 926] is necessary because a municipality might, ***by reason of political pressure or desire for future good relations with a particular creditor or class of creditors***, make payments to such creditors in the days preceding the petition to the detriment of all other creditors. No change in the elected officials of such a city would automatically occur upon filing of the petition, and it might be very awkward for those same officials to turn around and demand the return of payments following the filing of the petition. ***Hence, the need for a trustee for such purpose***.

S. Rep. No. 95-989, at 68 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5795 (emphasis added).[10] Under the City's logic, Congress drafted one provision (section 904) that expressly nullifies another contemporaneously-drafted provision of the very same chapter of the very same statute. *See In re N.Y. City Off-Track Betting Corp.*, No. 09-17121(MG), 2011 Bankr. LEXIS 319, at *17 (Bankr. S.D.N.Y. Jan. 25, 2011) (The "contention that section 904 prohibits a court from appointing a trustee without the consent of the debtor renders section 926 mere surplusage."). Basic rules of statutory construction compel the opposite conclusion. *Weinberger v. Hynson, Westcott & Dunning, Inc.*, 412

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[9] Thus, court approval of proposed settlements respecting disputed prepetition claims is necessary because an incorporated provision of the Bankruptcy Code (section 502) requires it. In contrast, because no incorporated provision of the Bankruptcy Code requires court approval of a debtor's payment of undisputed prepetition claims, section 904 prohibits the Court from enjoining such payments.

[10] The COLLIER ON BANKRUPTCY passage cited by the City in this regard directly conflicts with this clear legislative history. City Br. at 14-15.

U.S. 609, 633 (1973) (applying the "well-settled" rule of statutory construction requiring that courts give independent and internally consistent importance to each term in a statute).

Indeed, the City appears not to believe its own rhetoric with respect to the incorporated provisions of the Bankruptcy Code. Just days ago, the City filed a motion (to be heard at the same time as the rescheduled hearing on the 9019 Motion) to assume a "Master Lease – Purchase Agreement" regarding the acquisition of new fire engines. [Dkt. No. 675] One cannot conceive of something more closely related to the City's "political or government functions" than the purchase of new fire engines. Accordingly, applying the City's own logic, section 904 would "trump" section 365 and nullify any statutory requirement for Court approval to assume the contract at issue. The City, however, properly seeks the Court's approval of the proposed assumption, as required by section 365. The City's inconsistent conduct only serves to highlight the vacuity of its legal position with respect to the 9019 Motion.

IV. SECTION 903 OF THE BANKRUPTCY CODE DOES NOT LIMIT THE COURT'S AUTHORITY TO REVIEW SETTLEMENTS

CalPERS devotes seven pages of its brief to the meaning and purpose of section 903 of the Bankruptcy Code, a provision that CalPERS claims to enable the State to continue to control the City during the bankruptcy case. CalPERS Br. at 13-19. The Court already has considered this topic at length, *see City of Stockton*, 478 B.R. at 14-17, and reached a conclusion that CalPERS now attacks. *See* CalPERS Br. at 16 (criticizing *City of Stockton*, 478 B.R. at 17-18, as "render[ing] 903 meaningless surplusage").

CalPERS' extensive attention to this topic is curious, as its interpretation of section 903 is utterly irrelevant to the Court's disposition of the 9019 Motion. The State has not demanded that the City settle the Hallon claim at issue or otherwise attempted to "control" the City in this regard, nor is CalPERS the State. Rather, in submitting its brief, CalPERS transparently is attempting to pre-litigate a question that, while it ultimately may become a major issue in this case, is not now before the Court: the ability to impair the City's largest liability (its obligation to CalPERS) through a plan of adjustment.

The Capital Markets Creditors reserve all rights with respect to that important, potentially case dispositive issue, as to which CalPERS is demonstrably wrong.[11] For present purposes, it is sufficient to note that even if the State had attempted to "control" the City with respect to settlement of the disputed prepetition Hallon claim or any other disputed prepetition claim, which it has not, the State's efforts at "control" would be preempted by the core provisions of the Bankruptcy Code governing adjustment of the debtor-creditor relationship.

To start, there is no question that, absent State consent, the Tenth Amendment prohibits a municipality from seeking bankruptcy protection or otherwise impairing or discharging its obligations in violation of applicable state law. That is the fundamental holding of CalPERS' primary case, *Ashton v. Cameron County Water Improvement District Number One*, 298 U.S. 513 (1936), in which the Supreme Court held unconstitutional the first municipal bankruptcy law because it enabled municipalities to seek bankruptcy protection even over the objection of the state in which they were located. *Id.* at 531.

By the same token, however, there also is no question that, ***where the state consents***, the Tenth Amendment provides no barrier to municipal bankruptcy. That is the fundamental holding of *United States v. Bekins*, 304 U.S. 27 (1938), decided two years after *Ashton*, in which the Supreme Court held chapter 10 of the Bankruptcy Act (the precursor to chapter 9 of the Bankruptcy Code) to be constitutional because it was premised on state consent in the form of authorization for municipalities to seek bankruptcy protection. The Supreme Court explained that, with state consent, the municipal bankruptcy law provided a remedy that the states could not provide on their own due to the prohibitions of the Contracts Clause:

> In the instant case we have co-operation to provide a remedy for a serious condition in which the States alone were unable to afford relief. . . . The natural and reasonable remedy through composition of the debts of the district was not available under state law by reason of the restriction imposed by the Federal Constitution upon the impairment of contracts by state legislation. The bankruptcy power is competent to give relief to

[11] Among many other things, CalPERS is not an "arm of the state" cloaked with sovereign immunity (CalPERS Br. at 10 n.1) when it acts in its capacity as a creditor and contract counterparty of the City. Indeed, CalPERS brazenly implies that CalPERS itself is the "State" for purposes of sections 903 and 904. While it is unnecessary to litigate that outlandish proposition in the context of the 9019 Motion, the Capital Markets Creditors reserve all their rights to do so at the appropriate time.

> debtors in such a plight and, if there is any obstacle to its exercise in the case of the districts organized under state law it lies in the right of the State to oppose federal interference. The State steps in to remove that obstacle. ***The State acts in aid, and not in derogation, of its sovereign powers***. ***It invites the intervention of the bankruptcy power*** to save its agency which the State itself is powerless to rescue.

Id. at 53-54 (emphasis added).

State consent is the key. Once a state has authorized a municipality to seek bankruptcy protection the interests of state sovereignty are at an end with respect to fundamental bankruptcy issues regarding the adjustment of debts. Simply put, the authorization provisions "empower states to act as gatekeepers to their municipalities' access to Chapter 9. In turn, ***a state's authorization that its municipalities may seek Chapter 9 relief is a declaration of state policy that the benefits of Chapter 9 take precedence over control of its municipalities***." *In re City of Vallejo*, 432 B.R. 262, 267-68 (E.D. Cal. 2010) (emphasis added) [*Vallejo II*]. To hold otherwise would run afoul of the Bankruptcy Clause's provision for ***uniform*** bankruptcy laws:

> If chapter 9 permitted states to define all properties of the debtor in bankruptcy regardless of the situation and to rewrite bankruptcy priorities, then chapter 9 would become a balkanized landscape of questionable value. Moreover, chapter 9 would violate the constitutional mandate for ***uniform*** bankruptcy laws.

In re County of Orange, 191 B.R. 1005, 1020 (Bankr. C.D. Cal. 1996) (emphasis in original).

As a consequence, states are not free to pick and choose among the provisions of the Bankruptcy Code that they wish to have applied in any particular municipal bankruptcy case to which they have consented, including section 502 and the other fundamental debt-adjustment provisions that form the "core" of a chapter 9 case. As the Court has held, "[a] state cannot . . . condition or [] qualify, i.e. [] 'cherry pick,' the application of the Bankruptcy Code provisions that apply in chapter 9 cases after such a case has been filed." *City of Stockton*, 478 B.R. at 16; *see, e.g.*, *Vallejo II*, 432 B.R. at 267-68 (same); *In re City of Vallejo*, 403 B.R. 72, 76 (Bankr. E.D. Cal. 2009) [*Vallejo I*]; *County of Orange,* 191 B.R. at 1021 ("By authorizing the use of chapter 9 by its municipalities, California must accept chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest."); Ryan Preston Dahl, *Collective Bargaining Agreements and Chapter 9 Bankruptcy*, 81 Am. Bankr. L.J. 295, 333 (2007) ("Any attempt to limit a debtor's rights under § 365 through recourse to state sovereignty must also be weighed against the filing requirements unique to

Chapter 9. . . . Since the state must consent to a bankruptcy filing under § 109(c)(2), ***the state consents to the displacement of its own law in order to obtain the benefits uniquely available under the Bankruptcy Code***.") (emphasis added).[12]

While sections 109(c)(2), 903 and 904 of the Bankruptcy Code allow a state to establish rules for access to chapter 9 and protect a municipality from undue bankruptcy court interference with its governmental powers, those sections do not allow a state to modify or exempt itself from undesirable provisions of the Bankruptcy Code once authorization to file has been given. *See City of Stockton*, 478 B.R. at 16-17. Thus, for example, a state may not exempt its own claims from impairment in a lawfully commenced chapter 9 case. *Mission Indep. Sch. Dist. v. Texas*, 116 F.2d 175, 178 (5th Cir. 1940) ("The Bankruptcy Act as a law of Congress made in pursuance of the Constitution of the United States, is part of the supreme law. It makes no provision for separate or preferential treatment of a bondholding state as a creditor."). Nor can a state attempt to alter the provisions of section 365 in a chapter 9 case: "Assuming for sake of argument that California law superimposes its labor laws onto section 365, such law would be unconstitutional. . . . '***[I]ncorporat[ing] state***

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[12] CalPERS misleadingly states that one of the Capital Markets Creditors, Assured Guaranty Municipal Corp., disagreed with this basic proposition in the *Jefferson County* bankruptcy case. Despite selective "cherry-picking" of passages, even a quick reading of the brief cited by CalPERS demonstrates the contrary.

In *Jefferson County*, as a result of litigation commenced approximately three years before the chapter 9 filing, an Alabama State Court had appointed a receiver to take possession and control over the County's sewer system. After the County filed for bankruptcy, holders of sewer system warrants, along with insurers of those warrants and the indenture trustee, challenged the County's first-day attempt to regain control of the sewer system. In a decision it recognized was one of "first impression," the bankruptcy court held that it had jurisdiction over the sewer system and directed the receiver to transfer possession and control of the system back to the County.

The bankruptcy court then *sua sponte* certified its decision for direct appeal to the Eleventh Circuit. In the appeal, the creditors argued that section 903 of the Bankruptcy Code prevented the bankruptcy court from interfering with the sovereign's control over its municipality, *i.e.* the state's control over the sewer system. The main thrust of the creditors' argument is that the sovereign State of Alabama, through its state court, already had possession and control of the sewer system by the time the County filed its petition, and therefore was exercising "political and governmental control" over its municipality – precisely what section 903 is designed to protect.

The argument that a bankruptcy court may not interfere with a State's prepetition exercise of control over its municipality does not remotely contradict the basic proposition that a State consents to the application of the Bankruptcy Code sections incorporated into chapter 9, and does nothing whatsoever to support CalPERS's assertion that sections 903 and 904 somehow prohibit the Court from evaluating postpetition compromises and settlements under Rule 9019 and the claim allowance process of section 502.

substantive law into chapter 9 to amend, modify or negate substantive provisions of chapter 9 would violate Congress' ability to enact uniform bankruptcy laws.'" *Vallejo I*, 403 B.R. at 76-77 (emphasis added) (citations omitted); *accord Vallejo II*, 432 B.R. at 270 ("incorporating state labor law is, as the Bankruptcy Court so found, prohibited by the Supremacy Clause, the Uniformity [Bankruptcy] Clause and the Contracts Clause."). CalPERS's own authority makes this very point. *In re New York City Off-Track Betting Corp.*, 434 B.R. 131, 144 (Bankr. S.D.N.Y. 2010) ("Section 903 also indicates that with regards to debt readjustment of municipal entities, ***chapter 9 preempts any coordinate state law***.") (emphasis added).

In sum, CalPERS' invocation on section 903 is unavailing. Section 903 does not provide any substantive limit on the application of the Bankruptcy Code sections incorporated into chapter 9, including, without limitation, section 502. Rather, section 903 merely affirms that chapter 9, by its terms and operation, appropriately reserves the power of the state to control a municipal debtor in the exercise of its political and governmental powers in accordance with the Tenth Amendment as to matters unrelated to the debt adjustment process that is at the core of chapter 9. *See County of Orange*, 191 B.R. at 1017, 1021 (noting that federal preemption with respect to bankruptcy and debt adjustment matters does not interfere with the political or governmental powers of the state).[13]

V. THE APPROPRIATE "POLICING" MECHANISM IS CONCURRENT REVIEW OF PROPOSED SETTLEMENTS

CalPERS argues that the Court's concerns about the need to have "some kind of protection or policing" with respect to settlements of prepetition claims are unfounded because the Court is free to dismiss the case or deny confirmation of a plan. CalPERS Br. at 5-6.[14] CalPERS, however, then

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[13] Similarly, CalPERS's assertion that section 943(b)(4) of the Bankruptcy Code somehow ensures the primacy of state control over core bankruptcy matters, CalPERS Br. at 17, is dead wrong. Section 943(b)(4) – which permits confirmation of a plan of adjustment if "the debtor is not prohibited by law from taking any action necessary to carry out the plan" – only "applies to ***postpetition actions after confirmation of the plan***." *In re City of Columbia Falls*, 143 B.R. 750, 760 (Bankr. D. Mont. 1992) (emphasis added). The contrary reading urged by CalPERS would make no sense: "To create a federal statute based upon the theory that federal intervention was necessary to permit adjustment of a municipality's debts and then to prohibit the municipality from adjusting such debts [due to alleged prohibitions in state law] is not, in the point of view of this Court, a logical or necessary result." *Id.* (internal citations omitted).

[14] CalPERS also asserts that state law regarding the nature and notice of settlements should control. CalPERS Br. at 6-8. As explained above, this is precisely backward because the City has now consented to application of federal bankruptcy law governing the debt adjustment process,

contradicts itself, stating that section 943 (setting forth requirements for confirming a chapter 9 plan of adjustment) "says nothing about the management of the debtor's property during the pendency of the case or the settlement of claims." *Id.* at 4. The City, for its part, asserts that settlements made during a bankruptcy case have "no direct connection to" and hence are irrelevant in the context of the plan confirmation process. City Br. at 18-19.

Taken to their illogical conclusion, these arguments turn the Bankruptcy Code's careful balance of debtor and creditor protections on its head, and would create a whipsaw effect that ultimately would eviscerate the Court's ability to evaluate a plan of adjustment. The City wants both to have its cake – the ability to settle and pay any and all disputed prepetition claims – and then eat it too – by interpreting sections 943 and 1129 as present – and forward – looking only. If the City were right, the Court would have no authority or oversight over any of the City's actions during the chapter 9 case – because all such actions are authorized unless the City deigns to consent to the Court's review – but the Court then would have no basis to deny confirmation on account of those same actions because they were authorized at the time they were made.

This "heads, I win; tails, you lose" argument makes no sense. At a minimum, one of two necessary outcomes must follow: (a) either the Court has the power and authority to act now, or (b) the creditor protections contained in sections 943 and 1129 (such as the prohibition on unfair discrimination, the fair and equitable test, and the best interests of creditors test) must be considered in light of the City's actions throughout the case. Any interpretation of chapter 9 that permits the City to eviscerate all creditor protections and rights by implementing a plan of reorganization before even proposing it would make a mockery of the Contracts Clause and the constitutional concerns the City and CalPERS so loudly declaim.

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including bankruptcy law with respect to the approval of proposed compromises. In any event, CalPERS's envisioned regime in which state law and state courts provide the appropriate forum and rule of decision would be the antithesis of a "collective proceeding to work out a comprehensive solution to municipal insolvency," *City of Stockton*, 478 B.R. at 26, and would create exactly the "balkanized landscape of questionable value" previously rejected by bankruptcy courts, *County of Orange,* 191 B.R. at 1020. CalPERS' argument on this point does nothing other than underscore its overarching worldview – that the bankruptcy law and bankruptcy courts have no real power over or business being involved in any determination that may affect CalPERS's interests. This view has no supportable basis in fact or law.

In the present context, the Capital Markets Creditors submit that the better time to "police" proposed settlements is at the time the City seeks to consummate them, and not after the fact. Once consummated, a settlement may be very difficult, if not impossible, to undo, even where the settlement may have a profound impact on the substance of a plan of adjustment and the Court's consequent determinations with respect to whether the plan satisfies the applicable confirmation requirements.

Consider, for example, a pre-plan settlement by the City that provides for payment in full of a very large disputed claim. If the City subsequently were to propose a plan of adjustment that provided for similarly-situated claims to be discharged at cents on the dollar, it is hard to see how the City could satisfy the statutory requirements of equal treatment of similarly-situated claims and protection against unfair discrimination. To the extent that the compromise depleted the City's resources available to pay claims, the compromise also would fail the "best interests of creditors" test. And any such settlement surely would impact the Court's assessment of the City's good faith in the case. *See* CMC Supp. Br. at 9-11.

As such, waiting until the time of plan confirmation to assess the propriety of the City's various pre-plan compromises would put the Court in the difficult position of refusing to confirm a plan (other than one requiring rescission of objectionable compromises) or mandating dismissal of the case (for, by definition, the City would be unable to confirm a plan having consummated one or more settlements that rendered it unable to satisfy the Bankruptcy Code's confirmation requirements). There is no reason to believe that Congress intended such a backwards and inefficient process.

The time to review a settlement in a chapter 9 case is when the agreement is made and before it is consummated, just like in cases commenced under every other chapter of the Code. As a result, even if the Court concludes that chapter 9 itself does not mandate such contemporaneous review, the Court can and should inform the City that it may dismiss this case in the event the City enters into a material compromise without first submitting the settlement for Court approval. *See* 11 U.S.C. § 930.

WHEREFORE, the Capital Markets Creditors respectfully request that this Court hold that the City is required to seek and obtain the approval of the Court before implementing any proposed compromise of its prepetition liabilities, and therefore deny the 9019 Motion to the extent that it seeks to exempt the City from so doing and grant such other and further relief as is just and proper under the circumstances.

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