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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re:

CITY OF STOCKTON, CALIFORNIA,

Debtor.

ASSOCIATION OF RETIRED EMPLOYEES OF THE CITY OF STOCKTON, a nonprofit California corporation, SHELLEY GREEN, PATRICIA HERNANDEZ, REED HOGAN, GLENN E. MATTHEWS, PATRICK L. SAMSELL, ALFRED J. SIEBEL, BRENDA JO TUBBS, TERRI WILLIAMS, on Behalf of Themselves and Others Similarly Situated,

Plaintiffs,

v.

CITY OF STOCKTON, CALIFORNIA,

Defendant.

Case No. 12-32118

Chapter 9

Adv. No. 2012-02302

CITY OF STOCKTON'S RESPONSE TO PLAINTIFFS' SUPPLEMENTAL BRIEF IN SUPPORT OF APPLICATION FOR TEMPORARY RESTRAINING ORDER AND PRELIMINARY INJUNCTION OR IN THE ALTERNATIVE RELIEF FROM STAY

Date: July 23, 2012
Time: 1:30 p.m.
Courtroom: 35
Judge: Hon. Christopher Klein

Pursuant to the Court's July 12, 2012 Order, Adv. Dkt. No. 53, the City of Stockton, California (the "City"), submits this response to Plaintiffs' Supplemental Brief filed July 18, 2012, Adv. Dkt. No. 56:

I. INTRODUCTION

The Court's July 12 Order directed Plaintiffs to file a brief "explaining why any of the relief sought in the complaint can be awarded, without the consent of the debtor, in light of 11 U.S.C. § 904." The City does not consent to the Court hearing this adversary proceeding, and Plaintiffs have failed to carry their burden of overcoming the plain language of § 904. Accordingly, the Court should dismiss the adversary proceeding. Nor should the Court grant Plaintiffs' alternative request for relief from the automatic stay. First, this relief was not "sought in the complaint" and thus should not be considered by the Court at the July 23 hearing. Second, whenever the Court considers a procedurally proper request to lift the stay, it should deny it because granting relief from the stay would effectively leave the City without the protections of chapter 9, give Plaintiffs an unfair advantage over all the City's other prepetition creditors, and encourage if not compel all other creditors to seek similar relief.

II. SECTION 904 PROHIBITS THE COURT FROM INTERFERING WITH THE CITY'S BUDGET PROCESS

Amazingly, Plaintiffs claim that they are not asking "the Court to commit the City . . . to allocate its resources in a particular manner" or "to elevate one City function over another." Supp. Brief 1-2. But this is *exactly* the relief sought: an order compelling the City to pay benefits, which would directly affect the City's cash flow and constitute interference with the City's revenues. As is apparent from the City's Pendency Plan, were the City to pay retiree medical benefits in full during the pendency of this case, it necessarily would have to strip funding from some other service, be it police or fire staffing, road paving or a quality-of-life program. *See* Exhibit M To Declaration of Vanessa Burke In Support Of Statement Of Qualifications, Dkt. No. 64. The City's budget process represents possibly the most critical and difficult legislative judgment made by the City Council each year. An order compelling the City to make such payments would amount to this Court tinkering with the budget by determining that the City must

maintain medical benefits. It would then fall on the City Council to decide—contrary to its prior adoption of the Pendency Plan—whether to lay off public safety officers below what are already dangerously low levels, close City offices or shut down City services, or take some other measure. Not only is the Court not in any position to make these difficult municipal operations choices, it is expressly prohibited from doing so by 11 U.S.C. § 904. *See, e.g.*, *In re Addison Cmty. Hosp. Auth.*, 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994) ("[Section 904] makes clear that the court may not interfere with the choices a municipality makes as to what services and benefits it will provide.").

Section 904's command is clear: "A bankruptcy court may not interfere with a chapter 9 debtor's political or governmental powers, or the use of the debtor's property, without the debtor's consent." *In re New York City Off-Track Betting Corp.*, 434 B.R. 131, 140 (Bankr. S.D.N.Y. 2010). Thus, § 904 "prohibits bankruptcy courts from mandating that a chapter 9 debtor make specific payments in violation of the Tenth Amendment." *Id.; see also In re County of Orange*, 179 B.R. 195, 200 (Bankr. C.D. Cal. 1995) ("An order by me that the County pay professionals on an interim basis would constitute interference with the 'property or revenues' of the debtor."). It also means that the "court is not to involve itself with the day to day operations of the municipality." 10 COLLIER ON BANKRUPTCY ¶ 904.01[2] (Alan N. Resnick & Henry J. Sommer eds. 16th ed. 2011) ("COLLIER").[1]

Such limitation is consistent with Congress's intent, in the most recent substantive amendments to § 904, to "strengthen[] the independence of municipalities from the control of a bankruptcy court." COLLIER ¶ 904.LH[3]. For unlike other chapters of the Bankruptcy Code, "Chapter 9 does not attempt to balance the rights of the debtor and its creditors, but rather, to

[1] Other scholarly opinions are in accord with *Collier*. *See, e.g.*, Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 463 (1993) ("The effect [of § 903 and § 904] is to preserve the power of political authorities to set their own domestic spending priorities, without restraint from the bankruptcy court."); *id. at* 474 ("[T]he court may not order reductions in expenditure, sale of property, renegotiation of contracts, or increase in taxes"); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 283, 300 (2012) ("The House Report on the 1978 amendments to Chapter 9 indicated that the limitations of § 904 were constitutionally mandated, and that the section 'makes clear that the court may not interfere with the choices a municipality makes as to what services and benefits it will provide to its inhabitants.'") (citing legislative history); Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 373 (2010) ("[A]s long as the bankruptcy process continues, the locality is not required to make any payments on account of its pre-petition debt.").

meet the special needs of a municipal debtor." *In re Richmond Unified Sch. Dist.*, 133 B.R. 221, 225 (Bankr. N.D. Cal. 1991).

Plaintiffs attempt to avoid the straightforward application of § 904 by suggesting that they are entitled to some sort of priority over the claims of other creditors because their benefits are "vested." But even if Plaintiffs ultimately prove that a "contract" between them and the City existed under which the City was obligated to provide lifetime health benefits,[2] the City's medical obligations to retired employees would be non-executory, prepetition, contractual debts. *See In re UAL Corp.*, 468 F.3d 444, 455 (7th Cir. 2006) ("The supplemental benefits were deferred compensation for labor the retired pilots furnished before United entered bankruptcy. The retirees were unsecured creditors with respect to these benefits."). Such debts are similar to the bond obligations also impaired under the Pendency Plan and any other contracts under which the City has ceased performing. Compelling the City to pay this particular prepetition debt thus would not only violate § 904, it also would be inconsistent with the broader bankruptcy policy of treating unsecured creditors equally and, absent Bankruptcy Code authority, not paying one prepetition debt over another. *See In re KMart Corp.*, 359 F.3d 866, 872 (7th Cir. 2004) ("Filing a petition for bankruptcy effectively creates two firms: the debts of the pre-filing entity may be written down so that the post-filing entity may reorganize . . . .").

Nor does the *Orange County* decision cited by Plaintiffs offer a way around the plain language of § 904. Supp. Brief 3-4. At the outset, the City notes that this opinion contains no discussion of § 904. Moreover, the opinion followed a hurried hearing involving facts far more egregious than those present here.[3] 179 B.R. 177 (Bankr. C.D. Cal. 1995). Also, *Orange County* involved the pre-assumption or rejection treatment of the debtor's obligations under executory contracts, which themselves constitute a unique specie of unsecured prepetition debt. Finally, *Orange County*'s treatment of the labor agreements at issue was premised not on "legal" grounds

[2] At this time, the City does not concede that such a contract existed.

[3] As explained in the City's Memorandum Of Fact And Law In Support Of Statement Of Qualifications, retiree medical benefits have been and continue to be a known and major fiscal risk factor for the City. Dkt. No. 19. The Plaintiffs have been on notice since at least May 7 of the City's intent to reduce benefits, as will be demonstrated by the "Ask" the City will file later today. This is in sharp contrast to *Orange County*, which involved measures hurriedly imposed on County employees whose compensation and benefits had nothing to do with the County's fiscal challenges. 179 B.R. at 179-80.

but on "an equitable standpoint," 179 B.R. at 184, and has been disagreed with by subsequent courts and criticized by commentators. *See In re City of Vallejo*, 403 B.R. 72, 77-78 (Bankr. E.D. Cal. 2009), *aff'd*, 432 B.R. 262, 270 (E.D. Cal. 2010); COLLIER ¶ 901.04[9](a) (in discussing the tension between *Vallejo* and *Orange County*, "the better-reasoned view is that, notwithstanding applicable state law governing collective bargaining, a chapter 9 debtor is not bound by a prepetition CBA prior to rejection or assumption, although nonperformance by the debtor may give rise to a prepetition claim for damages"); Richard W. Trotter, *Running on Empty: Municipal Insolvency and Rejection of Collective Bargaining Agreements in Chapter 9 Bankruptcy*, 36 S. ILL. U. L.J. 45, 73 (2011) ("[T]he District Court in *Vallejo* realigns Chapter 9 jurisprudence with the Supreme Court's interpretation of Sections 1113 and 365, leaving *Orange County* as the outlier with respect to the issue of rejection").

III. THE PENDENCY PLAN IS NOT A PLAN OF ADJUSTMENT

Equally baseless is Plaintiffs' suggestion that the Pendency Plan somehow represents a "plan of adjustment." Supp. Brief 4. The City, unlike a private company, cannot simply go out of business. Though insolvent, it needs an operating budget to continue providing services, however limited, to its residents. The Pendency Plan is entirely consistent with chapter 9's purpose of providing the City with "temporary protection from debt collection efforts so that it may *establish* a plan of adjustment." *In re Valley Health Sys.*, 383 B.R. 156, 163 (Bankr. C.D. Cal. 2008) (emphasis added); *see also In re City of Vallejo, Cal.*, No. 08-26813-A-9, 2008 WL 4180008, at *21 (Bankr. E.D. Cal. Sept. 5, 2008) ("The City implemented the Pendency Plan as a bridge between the City's filing of its petition and the development and implementation of a plan of adjustment."); *Int'l Ass'n of Firefighters, Local 1186 v. City of Vallejo (In re City of Vallejo)*, 408 B.R. 280, 295 (B.A.P. 9th Cir. 2009) (Vallejo's Pendency Plan was not in itself a plan of adjustment, but demonstrated that it was designed to "result in an eventual plan of adjustment").

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IV. GRANTING RELIEF FROM THE AUTOMATIC STAY WOULD BE CONTRARY TO THE FUNDAMENTAL PURPOSES OF CHAPTER 9

As noted in the Introduction, the complaint did not seek relief from the automatic stay, and thus the July 12 Order did not serve to place the request in the Supplemental Brief at issue at the July 23 hearing. Nor is the motion for relief from the stay filed July 18 before the Court on July 23 because, despite Local Rule 9014(f)(3), no application to shorten notice has been filed or granted.

But even if the Court could properly consider the motion for relief from the stay at the July 23 hearing, the Court should deny the request because Plaintiffs here are in no different position than many other prepetition creditors of the City. Granting them relief from the automatic stay would open the floodgates to similar requests and would deprive the City of the protections chapter 9 was intended to provide.

In an *Orange County* matter unrelated to labor issues, noteholders filed a motion for relief from the automatic stay to file a writ of mandate complaint in state court to force Orange County to set aside certain pledged revenues for payment on prepetition, contractual indebtedness, i.e., virtually identical relief to that sought here. *See In re County of Orange*, 179 B.R. 185 (Bankr. C.D. Cal. 1995), *rev'd in part*, 189 B.R. 499 (C.D. Cal. 1995); *see also* COLLIER ¶ 903.02. The *Orange County* court denied the motion. As part of its analysis, the court rejected the creditors' attempts to use 11 U.S.C. § 903 to have their contractual prepetition claims heard in state court:

> The problem with the Movants' argument is that if they are correct, no municipality would file Chapter 9 because the benefits of filing would disappear. California specifically authorized its municipalities to seek the protection of Chapter 9. The two main benefits of a Chapter 9 filing are (1) the breathing spell provided by the automatic stay, and (2) the ability to adjust debts of claimants through the plan process. If the automatic stay is to be lifted routinely to allow claimants to assert their claims in state court, a municipality will not have the time, opportunity or ability to confirm a plan.

179 B.R. at 190. The same logic applies here.

Moreover, were a state court to hear the matter and order the City to make the payments sought by Plaintiffs, it would be determining the treatment of prepetition debts outside the

structure of a plan of adjustment and without the protections and procedures provided to the City and other creditors by Bankruptcy Code § 943 and the various provisions of Subchapter II of chapter 11 incorporated into chapter 9 by § 901.

Finally, lifting the automatic stay to allow Plaintiffs' lawsuit against the City will undoubtedly provoke similar motions from other creditors, who will feel compelled to race to the courthouse to obtain their shares of the City's dwindling assets. This will force the City to defend such actions, exhausting its resources and leaving it in a position no different than it would be outside of bankruptcy court. Cause does not exist to lift the automatic stay, and the Court should deny Plaintiffs' request when such request is properly before the Court.

V. CONCLUSION

Because the City does not consent to the Court hearing this adversary proceeding, the Court lacks jurisdiction under 11 U.S.C. § 904 to grant any of the relief requested by Plaintiffs in the adversary. Nor should the Court grant Plaintiffs' request for relief from the automatic stay—even if such a request were properly before it. The Court should dismiss the adversary proceeding.

Dated: July 20, 2012

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